STATE TAXATION OF NONRESIDENTS' PENSION INCOME

ING

THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

H.R. 371, H.R. 394, and H.R. 744

JUNE 28, 1995

Serial No. 11

Printed for the use of the Committee on the Judiciary

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STATE TAXATION OF NONRESIDENTS' PENSION INCOME

WEDNESDAY, JUNE 28, 1995

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND
ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2226, Rayburn House Office Building, Hon. George W. Gekas (chairman of the subcommittee) presiding.

Present: Representatives George W. Gekas, Bob Inglis, Steve Chabot, Jack Reed, and Robert C. Scott.

Also present: Charles E. Kern II, counsel; Rebecca Ward, secretary; and Agnieszka Fryszman, minority counsel.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. GEKAS. The hour of 10 o'clock having arrived, this session of the Commercial and Administrative Law Subcommittee of the Judiciary will come to order.

We will begin the hearing. I see now that Representative Stump has been joined by Representative Vucanovich, so once they take their place at the witness table, we can begin.

The issue before us is not as thrilling or as adventurous as to whether or not we should have a continuation of the B–2 program or any such thrilling kind of issue, but it is very important. It has to do with source taxation, a vexatious issue that touches many, many thousands of our fellow Americans and an issue which deserves our full attention.

The witnesses will cover the waterfront, as it were, from Members of the House of Representatives and the Senate plus people from academia who have analysis to offer on this issue, to people who are directly affected by it—retirees, employees, employers, tax administrators, et cetera.

So by the time we are finished with this hearing, we on the subcommittee will be better educated on how best to proceed. It is not a new issue, but we acknowledge and promise that it will become a fresher issue as a result of this hearing.

[The bills, H.R. 371, H.R. 394, and H.R. 744, follow:]

104TH CONGRESS
1ST SESSION

H. R. 371

To prohibit a State from imposing an income tax on the pension income of individuals who are not residents or domiciliaries of that State.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 4, 1995

Mr. STUMP (for himself and Mrs. VUCANOVICH) introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To prohibit a State from imposing an income tax on the pension income of individuals who are not residents or domiciliaries of that State.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. LIMITATION ON STATE TAXATION OF PENSION INCOME.

(a) IN GENERAL.—Chapter 4 of title 4 of the United States Code is amended by adding at the end thereof the following new section:

"§ 114. Limitation on State income taxation of pension income

"(a) No State may impose an income tax (as defined in section 110(c)) on the pension income of any individual who is not a resident or domiciliary of such State.

"(b) For purposes of subsection (a), the term 'State' includes any political subdivision of a State, the District of Columbia, and the possessions of the United States.".

(b) CLERICAL AMENDMENT.—The table of sections for such chapter 4 is amended by adding at the end thereof the following new item:

"114. Limitation on State income taxation of pension income."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

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104TH CONGRESS
1ST SESSION

H. R. 394

To amend title 4 of the United States Code to limit State taxation of certain pension income.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 4, 1995

Mrs. VUCANOVICH (for herself, Mr. ENSIGN, Mr. STUMP, Mr. DOOLITTLE, and Mr. BURTON of Indiana) introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To amend title 4 of the United States Code to limit State taxation of certain pension income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. LIMITATION ON STATE INCOME TAXATION OF CERTAIN PENSION INCOME.

(a) AMENDMENT.—Chapter 4 of title 4, United States Code, is amended by adding at the end the following:

"§ 114. Limitation on State income taxation of certain pension income

"(a) No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).

"(b) For purposes of this section—

"(1) The term 'retirement income' means any income from—

"(A) a qualified trust under section 401(a) of the Internal Revenue Code that is exempt under section 501(a) from taxation;

"(B) a simplified employee pension as defined in section 408(k) of such Code;

"(C) an annuity plan described in section 403(a) of such Code;

"(D) an annuity contract described in section 403(b) of such Code;

"(E) an individual retirement plan described in section 7701(a)(37) of such Code;

"(F) an eligible deferred compensation plan (as defined in section 457 of such Code);

"(G) a governmental plan (as defined in section 414(d) of such Code);

"(H) a trust described in section 501(c)(18) of such Code; or

"(I) any plan, program or arrangement described in section 3121(v)(2)(C) of such Code. Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code.

"(2) The term 'income tax' has the meaning given such term by section 110(c).

"(3) The term 'State' includes any political subdivision of a State, the District of Columbia, and the possessions of the United States.

"(c) Nothing in this section shall be construed as having any effect on the application of section 514 of the Employee Retirement Income Security Act of 1974.".

(b) CONFORMING AMENDMENT.—The table of sections for chapter 4 of title 4, United States Code, is amended by adding at the end the following:

"114. Limitation on State income taxation of certain pension income".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts received after December 31, 1994.

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104TH CONGRESS
1ST SESSION

H. R. 744

To limit State taxation of certain pension income, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 30, 1995

Mr. PICKETT introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To limit State taxation of certain pension income, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. LIMITATION ON STATE TAXATION OF CERTAIN PENSION INCOME.

(a) IN GENERAL.—Chapter 4 of title 4, United States Code, is amended by adding at the end the following new section:

"§ 114. Limitation on State income taxation of pension income

"(a) No State may impose an income tax (as defined in section 110(c)) on the qualified pension income of any

individual who is not a resident or domiciliary of such State.

"(b)(1) For purposes of subsection (a), the term 'qualified pension income' means any payment from a qualified plan—

"(A) which is part of a series of substantially equal periodic payments (not less frequently than annually) made for—

"(i) the life or life expectancy of the recipient or for the joint lives or joint life expectancies of the recipient and the recipient's designated beneficiary, or

"(ii) a period of not less than 10 years, or

"(B) which is not described in subparagraph (A) and which—

"(i) is received in a taxable year for which an election under this subsection is in effect, and

"(ii) is received on or after the date on which the recipient has attained the age of 59½,

except that the aggregate amount of payments to which this subparagraph may apply for any taxable year shall not exceed $25,000.

"(2) For purposes of paragraph (1), the term 'qualified plan' means—

"(A) an employees' trust described in section 401(a) of the Internal Revenue Code of 1986 which is exempt from tax under section 501(a) of such Code,

"(B) a simplified employee pension described in section 408(k) of such Code,

"(C) an annuity plan described in section 403(a) of such Code,

"(D) an annuity contract described in section 403(b) of such Code,

"(E) an individual retirement plan described in section 7701(a)(37) of such Code,

"(F) an eligible deferred compensation plan under section 457 of such Code, or

"(G) a governmental plan described in section 414(d) of such Code, other than a plan established and maintained by a State or political subdivision of a State, or an agency or instrumentality of either.

"(3)(A) An election under paragraph (1)(B), once made for a taxable year, may not be made for any other taxable year.

"(B)(i) If more than 1 State would (but for paragraph (1)(B)) impose an income tax on qualified pension

income received by an individual during a taxable year, the dollar amount otherwise applicable under paragraph (1)(B) for such taxable year shall be allocated among such States in such amounts as such individual may determine.

"(ii) The Secretary of the Treasury shall prescribe regulations for the application of paragraph (1)(B) in any case in which more than 1 individual receive qualified pension income during a taxable year which is attributable to services performed by 1 individual.

"(C) In calendar years beginning after 1995, the $25,000 amount referred to in paragraph (1)(B) shall be increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of such Code for such calendar year by substituting 'calendar year 1994' for 'calendar year 1992' in subparagraph (B) thereof.

"(c) For purposes of subsection (a), the term 'State' includes any political subdivision of a State, the District of Columbia, and the possessions of the United States."

(b) CLERICAL AMENDMENT.—The table of sections for such chapter 4 is amended by adding at the end the following new item:

"114. Limitation on State income taxation of pension income."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

Mr. GEKAS. First, I would like to yield to the gentleman from Rhode Island, Mr. Reed, the ranking member on the minority, for his opening statement if he has one.

Mr. REED. Thank you very much, Mr. Chairman.

I would first like to start on a very positive note and commend you and your counsel, Charles Kern, for the way you have put this hearing together today. This is a model of how a hearing should work. We have cooperation, fair notice, and we will be able to hear from a range of witnesses with varying viewpoints. Sadly though, that model is not always used, and I will have some comments about that in a moment.

The subject of today's hearing, the source tax, is a very important one. Last year we supported legislation similar to many of the bills that are before us today. There is a difference from one of the bills, H.R. 394, and I believe we have to thoroughly examine this legislation. Last year's bill was limited to qualified pension plans and capped the exemption at $30,000 annually for all pension income, including lump sum payments as well as periodic payments.

I am concerned that H.R. 394 expands the coverage of legislation to nonqualified plans, which could create an opportunity for tax avoidance from the States for very highly compensated individuals, and I don't think that Congress should be in a position of providing escape hatches from State taxes for golden parachutes and other particularized and individualized retirement arrangements.

Recently we concluded extensive debate about allowing U.S. citizens to avoid tax liability by renouncing their citizenship, and there is something similar in this regard if someone could forgo their obligations to a State by simply declaring their residency in another State.

Again, I mentioned before, Mr. Chairman, that this hearing is one of, I think, a model of how it should be done, but unfortunately tomorrow's hearing is one that upsets this pattern. We have not yet been officially notified by staff of the witnesses. Indeed, I had to read about the witnesses in today's Congressional Monitor. I think it is unfair and unfortunate that the ranking member and the minority in general has to get its information from commercial sources rather than from direct contact with the staff.

I have been told that the administration has been placed on the third panel. In fact, I read it here. We haven't really been told anything. It is custom—and I think this custom was applied equally to Democratic and Republican administrations—to provide them an opportunity to testify in the first panel or certainly at least immediately following Members of Congress.

Also, there has been some discussion about witnesses on our side. We have made you aware of who we want as witnesses. There is some difficulty in getting in all the witnesses that we would like, particularly the Federal attorney from Kansas whom we requested to put on.

I would hope that between now and tomorrow, Mr. Chairman, we could work out these differences and, more importantly, we could resume the models of cooperation, collaboration, and I think effective hearings that I think have been established before and indeed represented by this particular hearing.

So I would ask your consideration, and I know working together we can probably resolve these problems. I am interested, as you are, in hearing these witnesses on this important topic.

Mr. GEKAS. Is the gentleman finished?

Mr. REED. I am finished.

Mr. GEKAS. I am disappointed that the gentleman chose this time, in front of this audience to launder internal bickering regarding situations that may have arisen. I resent any implication that you have stated or will state about any unfair treatment on the part of the Chair or the members of the majority of this subcommittee.

Given the acknowledgment by the gentleman from Rhode Island that in the past my counsels and I have communicated openly and fairly, and knowing that even if a meeting had happened tomorrow, a hearing at which some witnesses might appear who were not on the list or about which the gentleman from Rhode Island did not know, that we would give him ample opportunity for submission of written interrogatories, or a recall of those witnesses to another hearing or other witnesses to counter those who have testified. So we are going to put that aside for now, and if the gentleman wants to approach me privately again, we will do so. But I hope this doesn't establish a precedent whenever the minority has complaints about how the minority is being treated by the majority regarding a hearing that is not related to the subject-at-hand.

With that, we will proceed with the hearing, with no further comments from anyone. I will now acknowledge the presence of the lady from Nevada and ask her to proceed with her testimony.

STATEMENT OF HON. BARBARA F. VUCANOVICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

Mrs. VUCANOVICH. Thank you very much, Mr. Chairman and members of the subcommittee. I thought I was going to have flowers, a bouquet here.

Mr. GEKAS. I did promise you that, and then I remembered about the gift ban.

Mrs. VUCANOVICH. Right. That is it. Thank you very much. I want to thank you for holding this hearing on the pension source tax issue, and I might comment that Senator Reid is probably following me testifying at an earlier hearing, but as most of you know I was the first Member of Congress to introduce legislation prohibiting States from reaching across State lines to dip into the pocketbooks of retirees. It was in 1988 in the 100th Congress that I introduced a measure to stop States from taxing the pension income of nonresidents. I have introduced similar legislation in every Congress since then. My bill in this Congress, H.R. 394, currently has 111 cosponsors.

I first became aware of the source tax on retirees from Bill Hoffman, the founder of RESIST, from whom you will soon be hearing. Back then I thought that this tax on pensions was unfair. Some States are squeezing money from retirees who don't live in the taxing State and may not have lived there for years. These folks no longer receive any benefits from those States and cannot vote there. That is unfair. But the more I learn about how source-taxing

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States implement their source taxes on retirees, the more I think that it is not just unfair, it is unjust.

One of the principles of the source tax is that the State in which income is earned has the right to tax that income. I don't dispute this thesis one way or the other. However, even on the assumption that this principle is carved in stone, when States go to tax the income of retirees who have moved, they do far more than just recoup taxes that might be their due under this principle.

I am aware that testimony you will hear later today will explain what I am saying here in detail, so I won't belabor the point. But the fact is, given the data available, source-taxing States also actually tax more than just the amount that a retiree earned in the taxing State. Even in the best of situations, this can cause double taxation, and that is wrong.

But why should Congress step in? Isn't this an issue that should be left to the States? And aren't we trampling on States' rights if we enact legislation like H.R. 394?

Congress needs to step in, Mr. Chairman, because what is happening is wrong. Without congressional action, some States will continue to source tax retirees living in other States, violating in practice their own main principle that only the State of origin should have the authority to tax income. If this situation needs correcting, then it needs correcting by Congress.

On the issue of States' rights, I would like to make this point. The information does not exist for a State to determine the actual amount of a pension that was earned in that State. This means that source-taxing States are dipping into the coffers of other States. Take Nevada for example. A Nevada retiree paying a source tax to another State has that much less to spend in Nevada. Since we don't have an income tax and so rely heavily on sales taxes, we are losing out to the source-taxing State. I think H.R. 394 protects States' rights.

Finally, let me explain some changes in H.R. 394 as compared to the bill I introduced in the last Congress, which was H.R. 702. H.R. 394 differs in two ways from H.R. 702 in the 103d Congress. In the 103d Congress, H.R. 702 included a cap—and that was mentioned by Congressman Reed—included a cap on the amount of lump sum distributions exempted from the source tax. My new bill will have no caps.

As you will hear from subsequent testimony, including any caps at all is problematic. Also, it seems to me that if we prohibit the source tax we should not discriminate against retirees who are in different situations. The other change in my bill for this Congress is that the measure covers all retirement plans, not just those that qualify for special tax treatment by the Federal Government.

Again, it is a question of fairness to make the law apply equally to all retirees. These changes which extend the measure to all retirement income make the bill more fair because it will treat all retirees equal.

Thousands of retirees are asking us to protect them from the source tax on their pensions. I believe it is high time that we do that.

Thank you very much, Mr. Chairman, for allowing me to testify.

[The prepared statement of Mrs. Vucanovich follows:]

PREPARED STATEMENT OF HON. BARBARA VUCANOVICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

Good Morning Mr. Chairman and Members of the Subcommittee, I want to thank you for holding this hearing on the pension source tax issue. As most of you know, I was the first Member of Congress to introduce legislation prohibiting States from reaching across state lines to dip into the pocketbooks of retirees.

It was in 1988—in the 100th Congress—that I introduced a measure to stop states from taxing the pension income of non-residents. I have introduced similar legislation in every Congress since then. My bill in this Congress, H.R. 394, currently has 111 cosponsors.

I first became aware of the source tax on retirees from Bill Hoffman, the founder of RESIST, from whom you will soon be hearing. Back then, I thought that this tax on pensions was unfair. Some States are squeezing money from retirees who don't live in the taxing State and may not have lived there for years. These folks no longer receive any benefits from those States and cannot vote there. That's unfair.

But the more I learn about how source taxing states implement their source taxes on retirees, the more I think that it's not just unfair. It's unjust.

One of the principles of the source tax is that the State in which income is earned has the right to tax that income. I don't dispute this thesis one way or the other. However, even on the assumption that this principle is carved in stone, when States go to tax the income of retirees who have moved, they do far more than just "recoup" taxes that might be their due under this principle.

I am aware that testimony you will hear later today will explain what I am saying here in detail, so I won't belabor the point. But the fact is, given the data that is available, source taxing States actually tax more than just the amount that a retiree earned in the taxing State. Even in the best of situations, this can cause double taxation. That's wrong.

But why should Congress step in? Isn't this an issue that should be left to the States? And aren't we trampling on States' rights if we enact legislation like H.R. 394?

Congress needs to step in, Mr. Chairman, because what is happening is wrong. Without Congressional action, some States will continue to source tax retirees living in other States—violating, in practice, their own main principle that only the State of origin should have the authority to tax income. If this situation needs correcting, then it needs correcting by Congress.

On the issue of State's rights, I would like to make this point. The information does not exist for a State to determine the actual amount of a pension that was earned in that State. This means that source taxing States are "dipping" into the coffers of other States. Take Nevada, for example. A Nevada retiree paying a source tax to another State has that much less to spend in Nevada. Since we don't have an income tax, and so rely heavily on sales taxes, we are losing out to the source taxing State. I think H.R. 394 protects States' rights.

Finally, let me explain some changes in H.R. 394 as compared to the bill I introduced in the last Congress (H.R. 702). H.R. 394 differs in two ways from H.R. 702 in the 103rd Congress. In the 103rd Congress, H.R. 702 included a cap on the amount of lump-sum distributions exempted from the source tax. My new bill will have no caps. As you will hear from subsequent testimony, including any caps at all is problematic. Also, it seems to me that if we prohibit the source tax, we should not discriminate against retirees who are in different situations.

The other change in my bill for this Congress is that the measure covers all retirement plans, not just those that qualify for special tax treatment by the federal government. Again, it is a question of fairness to make the law apply equally to all retirees. These changes, which extend the measure to all retirement income, make the bill more fair because it will treat all retirees equally.

Thousands of retirees are asking us to protect them from the source tax on their pensions. I believe it is high time we do that.

Thank you, Mr. Chairman.

Mr. GEKAS. We thank the lady, and we now turn to the gentleman from Arizona, Mr. Stump.

STATEMENT OF HON. BOB STUMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Mr. STUMP. Thank you, Mr. Chairman, and let me thank you and the committee for allowing us to testify and for holding this meeting today.

I would ask unanimous consent that my statement be made a part of the record, and I will be very brief.

Mr. GEKAS. Without objection.

Mr. STUMP. Mr. Chairman, let me say that first I would like to commend my colleague, Barbara Vucanovich. She indeed was the leader in this effort, and because we share probably almost all of the California water between our two States, it is a particular problem to us because of the high taxes in California.

A lot of people who have fled California moved into our two States for that very reason, and it is just an issue of fairness, I did think, because California is now trying to collect their taxes while they still have to pay taxes in our respective States, as I am sure they do in all of your States if it becomes a problem with people moving in there.

I have my own bill, which was H.R. 371, but let me say that Barbara has a better bill. She delineates more thoroughly the types of pensions and covers them all, while mine refers to just pensions, period, and I would like to concur in her statement and her remarks and endorse her bill, H.R. 394.

Mrs. VUCANOVICH. Thank you very much.

Mr. STUMP. Mr. Chairman, I will answer any questions that you may have. With that, I will stop.

[The prepared statement of Mr. Stump follows:]

PREPARED STATEMENT OF HON. BOB STUMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Mr. Chairman, thank you for the opportunity to testify today on behalf of thousands of Arizona residents, as well as the residents of other states, who have fallen victim to what has become known as the "source tax." I would also like to thank my friend and colleague, Barbara Vucanovich, of Nevada, for her efforts to move this issue from one in which only a handful of Members had an interest, to one which has garnered the attention of the Subcommittee today.

I became involved in the source tax issue many years ago after several constituents contacted me regarding what they believed to be an error on the part of the California Franchise Tax Board. They had received notices from the State of California that they owed income taxes, and they were convinced that the notices were sent in error, as they had neither lived nor worked in California for many years. After making inquiries to the Franchise Tax Board, I was surprised to learn that the notices my constituents received were not sent by mistake; the State of California indeed expected them to file and pay California income tax, even though they were no longer California residents.

I am not an expert on the Constitutional and other legal intricacies of the issue before the Subcommittee today. However, I think I recognize unfairness when I see it. What has been going on over the past several years with regard to this issue has been not only unfair, it has been mean-spirited. For California and other states to say that anyone who has ever worked and earned a pension within their jurisdictions must pay income tax to them for the rest of their lives cannot be considered fair regardless of the arguments source-tax states put forward. My constituents and yours have been asked to pay income tax to a state in which they do not live, do not receive any of the benefits or services financed by those taxes and, most importantly, cannot vote against those who have levied the tax against them.

Earlier this year, Congresswoman Vucanovich and I introduced legislation that seeks to correct the current inequity toward our constituents and the thousands of others across the country who happen to have worked in one or more states during their careers but subsequently retired in a different state. While only a few states are now actively attempting to tax their former residents, many others contend that they have the authority to do so and are moving in that direction. This means that over time, retirees could be taxed on the same income by multiple state taxing jurisdictions because of the defects inherent in the various state crediting systems, as well as the different state tax rates. In addition, since employees may work in a number of states over their working careers, they as well as their employers and

retirement plan administrators would be faced with extensive record keeping, allocation and apportionment problems in trying to keep track of the correct amounts to be taxed by each of the states in which they had worked. Unless states are prohibited from taxing the pensions of non-resident retirees, more and more such retirees will be subject to double taxation, while an increasing number of their employers will be subject to overwhelming administrative costs and increasingly complex tax accounting problems.

My bill, H.R. 371, would prohibit a state from imposing an income tax on the "pension income" of any individual who is not a resident or domiciliary of that state. It is a straightforward and simple prohibition on the ability of states to coerce their former residents into paying income taxes for services they do not receive, or for policies and programs against which these former residents cannot vote. My bill, though, does not define the term "pension income," a fact which some in the pension area believe may lead to litigation in order to eliminate all uncertainties. This potential problem does not exist under H.R. 394, the bill introduced by Congresswoman Vucanovich, and which I was an original cosponsor. Her bill defines specifically what it is we seek to protect from out-of-state tax collectors.

It is my understanding that neither of our bills would result in a revenue loss to the U.S. Treasury. In fact, our legislation might even increase Federal revenues due to the fact that many retirees would claim smaller state income tax deductions against their Federal tax liability based upon the reduced state tax payment which would result from eliminating multiple state taxation.

I also understand that H.R. 394 has generated wide support from among the leading associations in the pension industry. The Profit Sharing Council of America, the ERISA Industry Committee, the Association of Private Pension and Welfare Plans, and the Committee on State Taxation have all stated their support, as well as the National Association of Retired Federal Employees, the National Association of Uniformed Services, the Airline Pilots Association and the National Society of Public Accountants.

Either of our bills would solve the problem of multiple-state taxing jurisdictions going after the retirement income of their former residents. They both represent a better approach than one which exempts only a specified amount of retirement income from tax, but allows states to go after whatever pension income exceeds the specified threshold. Protecting some, but not all of a retiree's pension from out-of-state tax collectors seems to me to be only a partial solution; in effect condoning source taxes and allowing states to violate the basic tenant that there should be no taxation without representation. It would as well create an accounting nightmare for employers who have employees in more than one state, or whose former employees no longer reside in the state in which they worked. Further, such an approach would not protect retirees who choose to take a lump sum distribution from their pension plan, or who happen to receive benefits from a plan which provides benefits in excess of the limitations imposed by the Internal Revenue Code for tax-qualified plans.

Retirees are justifiably upset when they are threatened or coerced into filing income tax returns and paying income taxes to states in which they no longer live. For many, the reason they no longer live in the state in which they worked was because of taxes and the fear that they could not live on a fixed retirement income and still pay the high taxes many states demand. They want us to put an end to the inequity which exists in paying income tax to a state they have long ago left, or the uncertainty of wondering when the long arm of the tax man will reach across the state border, or across the country.

In conclusion, I would ask that the Chairman and Members of this Subcommittee support the approach of H.R. 394—to remove the uncertainty and unfairness created by the existing state source tax by making clear that states cannot tax the retirement income of individuals who are not residents or domiciliaries of those states.

Mr. GEKAS. Yes. We will begin the questioning of our two colleagues who are present here pending the arrival of Senator Reid, and then we will interrupt the questions, seizing the prerogative of the Chair to do so, to allow the Senator to testify, and then we will resume the questioning.

The Chair will ask just a couple of routine questions.

You have properly stated that Nevada and Arizona are of course geographically touched by this problem. What can you tell the subcommittee about other States that may have the same problem,

perhaps not in quantity or volume or number of residents, but are there other States that are affected?

Mrs. VUCANOVICH. Of course there are, Mr. Chairman. There are States—naturally all of them are looking for revenue in these days, and I think that the State of New York collects and many other States that do or are considering collecting those, that they have the ability to do that. That is why we think before it gets too far out of hand that we need to speak up and change the law.

Now, California has a lot of citizens, and they have lots of needs for revenue, and they are, I use the word most aggressive of all of the States that I know that are doing that.

Now, there are other States, and there are some States that, because of this, have actually introduced State legislation preventing this from happening. Texas is one of those. But there probably are others who are doing it and are looking at it and Congressman Stump may know of others.

Mr. STUMP. Mr. Chairman, I would add one other State. That is Illinois.

California is our number one contributor as far as population goes, and Illinois is number two for moving into Arizona, and, as Barbara mentioned, New York is also one of those three. Just hearing from hundreds of constituents of mine that have moved from those areas, I know it is a problem there. I cannot tell you any other States.

Mr. GEKAS. Are there any Arizonians in Arizona?

Mr. STUMP. There are a few, but we are there.

Mr. GEKAS. The other question I have: Does anyone have a figure of what revenue loss this would cause to California? That is another part of what we must consider.

Mrs. VUCANOVICH. I would hope that some other people who will be testifying would know that. I don't happen to know.

Mr. STUMP. No, Mr. Chairman, I can't answer that either, I am sorry.

Mr. GEKAS. All right. I will reserve the balance of my question time and yield to the gentleman from Rhode Island for any questions that he might want to pose to our colleagues.

Mr. REED. Thank you, Mr. Chairman. I have no questions.

I want to commend both of my colleagues for your efforts. As you know, I support, as so many of us did last year, a variation of this legislation, and the two questions I have which I would like to explore with other witnesses are simply the elimination of the cap and inclusion of nonqualified pension plans. I think that is a technical question that we should address. But I commend you for your efforts and thank you.

Mrs. VUCANOVICH. Thank you.

Mr. GEKAS. The gentleman from South Carolina, whose presence is noted for the record, is now called upon to ask any questions or make any comments.

Mr. INGLIS. Thank you, Mr. Chairman.

I wonder, the rationale for California reaching out to these pension funds, is that that the corpus of the retirement fund remains located in California, or are they reaching out even—for example, if I have an IRA and I moved from California to Nevada or to Ari-

zona, are they also reaching out to that in an attempt to tax that, or only if the corpus remains in California?

Mrs. VUCANOVICH. If I understand the way they do that, it is whatever pensions are earned and invested—earned in the State, the source of the State, and again someone else may be able to enlighten a little bit more, but they are, and I don't know the answer to that. Whether those funds are taken to purchase an IRA, I don't know that, but whatever funds are earned as pensions in that State are subject to their tax.

Mr. STUMP. I would concur in that and also that that is what makes her bill better than mine, because she does delineate all the known pension taxes at least.

Mr. INGLIS. Are you familiar or aware of any litigation that any of those pensioners might have brought——

Mrs. VUCANOVICH. In some instances in my State they have been—the State of California has attempted to collect those, and our State passed a State law that said that they could not come in and take those. But, again, that is just on a very local basis, and whether they have actually come in and tried to collect those, I don't know, but they have filed suit against many people who live in my State.

Mr. INGLIS. I am of course in complete agreement with what you are attempting to do. I appreciate your work on it. I am just wondering where California would assert its right, particularly if the person has left the State and has taken the corpus with them. There seems to be no contact with the State of California.

Mrs. VUCANOVICH. They receive no benefits, and it seems terribly unfair. It seems to me that it is taxation without representation.

Mr. INGLIS. I wonder if anybody has brought any litigation to assert. It is not possible for the State of California to tax that. And of course, I also agree with you that it is important that we move to head this off so that other States don't get similarly creative.

Mrs. VUCANOVICH. I think the problem is, of course, we know that States are looking for revenue in every way, and they will look at every source, and I don't blame them, but a lot of people come to my State and I think also to Congressman Stump's because we have no State income tax, and we feel it is an attraction. Sometimes we think it is too much of an attraction. We have a lot more people moving into our State than we are able to handle with our resources, but if they come, we want them to be welcome and not be pursued by other States.

Mr. INGLIS. Thank you, Mr. Chairman.

Mr. GEKAS. The Chair notes the presence of the gentleman from Virginia, Mr. Scott, and turns to him for any opening statement that he might want to make or questions that he wants to pose to our colleagues.

Mr. SCOTT. Thank you, Mr. Chairman.

I am not sure I have a question, but my concerns are similar to the concerns of the gentleman from South Carolina because as you try to track the theory of this—and I am comfortable with the theory that theoretically the source State ought to be able to apply the tax, theoretically. My problem is that, in effect, I don't see any way you can do it fairly.

The gentleman from South Carolina mentioned IRA's and rollovers, and when you roll it over to another fund which came from California and which came from Virginia and which came from Illinois and how you apportion that, I don't know how you can do it fairly; you have got deferred income and pension income and different kinds of categories.

I guess we have got some witnesses that would know the technical answers to these questions, but I don't see how you can at all fairly apply this tax.

We have people here from States with no income tax. I would assume that there would be a tax credit, and I guess that is not a question for you because it wouldn't apply to you, but I would hope there would be a tax credit for taxes paid somewhere else, and then I assume the State really doesn't have to give a tax credit if it doesn't want to.

I mean there are a lot of technical questions that in the final analysis make these bills the proper course. Although theoretically we can tax, constitutionally we can probably do it, just from a practical, fair point of view, I don't see how we can do it, and I think the bills ought to be favorably considered.

Mrs. VUCANOVICH. I just would like to comment, too. We have so many people who worked, say, in the Federal Government or with corporations or in the military or whatever and earned their pensions in many different States, and that makes it very complicated, and it seems to me that it is totally unfair, and that is why we have pushed this.

But I think other people will be able, particularly people who have moved around from State to State in their employment. It makes it very difficult for them, but they can be subject to being taxed by many States many times.

Mr. GEKAS. The gentleman from Virginia reminds me that, looking at it from the standpoint of California for a moment so that we can get a full idea of the problem, the only nonresidents of which they would have recorded information and rolls, as it were, are retired State workers, it seems to me. But someone who worked for mom and pop in a grocery store and then moved to Arizona, how would they ever find out who that individual is? They would have to have a massive investigative force on the borders of Arizona and Nevada.

Mrs. VUCANOVICH. Almost, yes.

Mr. GEKAS. So it becomes now even a situation where the only ones who are affected by this unfairly are recorded employees like State pensioners.

Mrs. VUCANOVICH. That is true.

Mr. GEKAS. Where California actually has a record of who they are and to whom they send the pension checks, et cetera.

Well, any further questions on the part of anyone?

Mr. SCOTT. Let me just make another comment. The gentlewoman from Nevada pointed out that when you have a company, you have traveled around for that company, all they know is you have got one pension check, and they send that out to you into Nevada, and you may have five or six different States that want a little piece of it, and I just think the practical aspects make this im-

possible and if the States are going to insist on it, I think we ought to take Federal action to prohibit it.

Mr. GEKAS. Senator Reid is causing problems here.

Mrs. VUCANOVICH. We left him at a nuclear waste hearing. I testified and left.

Mr. GEKAS. All right. What we will do is proceed with the next panel and accommodate him when he should arrive. We thank our colleagues, and we will proceed expeditiously with consideration of the final version of this legislation.

Mrs. VUCANOVICH. Thank you very much. I appreciate it.

Mr. GEKAS. The next panel consists of a single witness, Prof. James C. Smith of the University of Georgia School of Law. We welcome him to the hearing and invite him to proceed with his testimony. We have a copy of his prepared statement which we will make a part of the record, without objection.

STATEMENT OF JAMES C. SMITH, PROFESSOR OF LAW, UNIVERSITY OF GEORGIA SCHOOL OF LAW

Mr. SMITH. Thank you, Mr. Chairman and members of the committee. I am honored by the invitation to return again to testify on the important issues being discussed today. I do not represent any client, public or private. I am here solely to present my own professional views on the subject.

Due process under the Constitution means the State must have some connection with the income it taxes. There are two bases for State taxation, both grounded in Supreme Court cases. Under the residence theory, a resident is taxable on all income, wherever earned. Under the source theory, a taxpayer is taxable on all income from sources within the State.

States that tax the pension income of their former residents are not exceeding the proper scope of their taxing authority. Due process is satisfied for two reasons. The person had the rights and privileges of residence while he or she earned the income, and under the source theory of taxation the income was generated by the performance of personal services within the State. It does not matter that the tax is assessed after the resident has permanently moved to another State and is no longer receiving benefits from the State where the pension was earned. The State provided the person with ample benefits while the income was being earned in the State.

Moreover, the State that taxes a former resident when pension payments are made is simply recovering revenues that were lost earlier due to the State's policy decision to permit deferral of recognition. The State could have taxed the pension rights prior to retirement when they were earned.

Even though the States are using their tax powers properly, Congress may legitimately elect to restrict the States. Congress has the authority under the commerce clause to prohibit State taxation of nonresidents' pension income.

To explain my opinion, it may be helpful to take a brief look at a recent landmark case from the U.S. Supreme Court. In April 1995, the Court decided *United States* v. *Lopez,* perhaps the most important case interpreting the commerce clause in more than 50 years, since a line of cases sustaining New Deal legislation.

Lopez holds that Congress cannot prohibit a person from possessing a gun in a school zone. Does *Lopez* mean that Congress cannot limit State taxation of nonresidents' pension income? No. *Lopez* is clearly distinguishable from our situation. *Lopez* is a change in direction in a line of cases involving a local activity, occurring within a single State, that is said to affect interstate commerce.

The activity being regulated under the proposed Federal pension legislation is the economic relationship between a State and its former resident. The transactions at issue are within the stream of interstate commerce. Both the person who has retired and the pension payments have crossed State lines.

Equity and efficiency are two primary tax concerns, and in this context, both equity and efficiency mean that a State which decides to tax the pensions of its continuing residents should also tax the pensions of its former residents. Otherwise, there is the risk that retirees who elect to stay in State will pay a tax that is not borne by the retirees who have moved elsewhere. This offends both equity and efficiency.

When the taxpayer retires to a State that taxes the pension income, the possibility of double taxation arises. This is not a major problem because virtually all States with broad-based income taxes give a credit to a resident who pays tax to a source State.

The critical issues raised by State taxation of nonresident pension income are practical, not constitutional or theoretical. States lack the constitutional power to tax that part of a nonresident's pension income that reflects accumulations after the taxpayer changes his or her residence. Thus, States generally cannot tax 100 percent of pension payments made to former residents. They must limit their tax to the income that was earned by the retiree in the State or that was accumulated while the retiree was a resident of the taxing State.

In addition, when a person works in more than one State prior to retirement, there is greater complexity. States must have a mechanism for tracing the precise amount of the pension income that is properly attributable to each taxing State. As a practical matter, the necessary records may not exist, and, even if they do, the task will often be very hard.

Although these difficulties may justify the proposed congressional restriction, there is the risk that States may react to such legislation by amending their tax laws to accelerate the recognition of retirement income.

States do not have to follow the Federal tax rules for deferring the recognition of pension income. They may either repeal deferred recognition as a general matter, taxing pension income as it accrues, for example, when contributions are made to a pension plan, or they may seek to tax departing residents on their accrued pension income during the year they change their residence.

Thank you. I will be very happy to answer any questions.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF JAMES C. SMITH, PROFESSOR OF LAW, GEORGIA UNIVERSITY SCHOOL OF LAW

I am James C. Smith, Professor of Law at the University of Georgia, where I have taught for the past eleven years. I am honored by the invitation to appear before

this Subcommittee to testify. I am not appearing on behalf of any client, public or private, but solely to present my own professional views on the subject.

While I teach and write in several different areas, I have written one book dealing with income taxation. In addition, I have written two articles, with Professor Walter Hellerstein as coauthor, that deal specifically with the interstate problems raised by State taxation of deferred income. Hellerstein & Smith, *State Taxation of Nonresidents Pension Income, Tax Notes,* July 13, 1992; Smith & Hellerstein, *State Taxation of Federally Deferred Income: The Interstate Dimension,* 44 Tax L. Rev. 349 (1989). I am submitting both articles for inclusion in the record.

CONSTITUTIONAL POWER OF STATES TO TAX NONRESIDENTS' PENSION INCOME

For a number of years, Congress has considered a variety of bills that have sought to bar States from taxing the pension income of their former residents. The first key question raised by such bills is whether States that tax the pension income of their former residents are properly exercising their powers. In particular, what if any limitations does the federal Constitution place on States when they tax their former residents' pension income? To phrase this another way, do former residents have a constitutional right that their pension income not be taxed by their former State?

Due process, broadly speaking, requires that the State have some connection with the income it seeks to tax. Obviously, a State cannot tax an individual who has never resided in or earned income in the State. A line of Supreme Court cases describe two fundamental but alternative predicates for State power to tax income: residence and source. When a State taxes the income of its resident, the theory is that the rights and privileges of residence justify taxing all of the resident's income, even if some or all of it is earned from out-of-State sources. Receipt of income by a resident is universally recognized as a proper basis for taxation. See *New York ex rel. Cohn* v. *Graves,* 300 U.S. 308, 312–13 (1937) (State may constitutionally tax resident on rents from land located in other State and on interest from mortgage-backed bonds located in other State).

The source theory of income taxation stems from the general dominion that the States have over all persons, property, and business transactions within their borders. The State, in addition to asserting dominion, protects the persons who earn income, their property, and the activities they pursue within the jurisdiction. See *Shatter* v. *Carter,* 252 U.S. 37, 50–51 (1920) (State may constitutionally tax nonresident who conducts business or carries on occupation within State).

From these two theories of taxing jurisdiction emerge the settled constitutional principles that a State may tax residents on their income from all sources and nonresidents on their income from sources within the State. These constitutional principles are reflected in the State statutes that generally tax residents on all of their income wherever earned while taxing nonresidents on their income derived from sources within the State.

The problem at hand, Stated generally, is how tax deferral fits in with the residence theory and the source theory of tax jurisdiction. States plainly possess the power under the due process clause to tax income derived from sources within the State, even if the income is recognized years later when the taxpayer no longer has any connection with the State. Whatever may be the practical problems in collecting a tax on such income, the constitutionally sufficient nexus that the State has with the income when it was earned does not evaporate merely because the income earner has severed his ties with the State and the State has chosen to postpone taxation of the income for policy reasons.

There is no sound theoretical basis for depriving States where deferred pension income is earned of the right to tax such income when it is recognized for federal income tax purposes merely because the retiree no longer resides in the taxing State. In fact, as a matter of theory, the opposite strategy is desirable. If States tax the deferred pension income of their continuing residents when it is federally recognized, in principle they should likewise tax the pension income of former residents to the extent it represents income earned while the taxpayer resided in the taxing jurisdiction.

POWER OF CONGRESS TO RESTRICT STATE TAXATION

Commerce Clause. Congress has the authority under the Commerce Clause to prohibit State taxation of nonresidents' pension income. The transactions at issue are within interstate commerce. Long ago a person's decision to move to another State and a person's receipt of pension payments may have been viewed as personal in nature, and not as "commerce," but modern Supreme Court cases define commerce expansively. See *City of Philadelphia* v. *New Jersey,* 437 U.S. 617, 622 (1978) ("commerce" includes all objects of interstate trade; movement of solid or liquid waste is

commerce); *United States* v. *South-Eastern Underwriters Ass'n,* 322 U.S. 533 (1944) ("commerce" includes fire insurance contract).

In April 1995, the United States Supreme Court decided *United States* v. *Lopez,* 115 S. Ct. 1624 (1995), perhaps the most important case interpreting the commerce clause in more than 50 years, since a line of cases sustaining New Deal legislation. *Lopez,* a five-to-four decision, holds that Congress cannot prohibit a person from possessing a gun in a school zone. The Court found that the federal criminal statute (the Gun–Free School Zones Act) regulated an intrastate activity that did not have a substantial effect on interstate commerce.

Does *Lopez* mean that Congress cannot limit State taxation of nonresidents' pension income? I am confident that the answer is no. Commerce clause jurisprudence is divisible into two main strains. First, there is a body of cases involving persons or things that travel, in a physical sense, from one State to another. Here, the subject matter is often said to be in the "stream of interstate commerce." Second, there are the cases involving a local activity, occurring with a single State, that is said to affect interstate commerce. *Lopez* is a local activity case, not one addressing the parameters of the stream of interstate commerce.

Unlike *Lopez,* the activity being regulated under the proposed federal pension legislation is the economic relationship between a State and its former resident. Both a person and a thing have crossed State lines. The taxpayer who is shielded by the legislation has moved from one State to another. Subsequently, the income that is being protected by the federal legislation moves interstate, from the State where it was earned or where the retirement plan is administered to the State of the retiree. The money moves by mail, electronic transfer between banks, or via some other interstate instrumentality. This money is in the stream of interstate commerce. Even if the transfer of money is not "commerce" itself, surely it affects interstate commerce because it impacts purchasing power of retirees in their new States. It affects markets in their new States. To the extent tax is paid to their State of former residence, they have less money to use, enjoy, or invest where they now live.

Tenth Amendment. A Tenth Amendment argument could be raised under *New York* v. *United States,* 505 U.S. 144 (1992), that Congress may not exercise its commerce power directly to regulate the States, but must limit its exercise to the regulation of individuals who are engaged in interstate commerce. *New York* held that Congress could not regulate the interstate disposal of low level radioactive waste by requiring that States regulate waste in accordance with Federal specifications. Moreover, Tenth Amendment concerns may be heightened to the extent that Congress prohibits States from taxing the pension income of former State employees. See *Garcia* v. *San Antonio Metropolitan Transit Authority,* 469 U.S. 528 (1985) (five-to-four decision), *overruling National League of Cities* v. *Usery,* 426 U.S. 833 (1976) (five-to-four decision).

Like *New York,* the proposed act to restrict State taxation of nonresident pension income does not primarily regulate private individuals; rather, it directly requires that the State refrain from taxing certain interstate transactions. For other reasons, however, a broad interpretation of *New York* so as to jeopardize the proposed prohibition of State taxation of nonresidents' pension income seems highly unlikely. *New York* focused on the Federal government ordering the States to regulate in a certain manner, rather than displacing State regulation. An affirmative command that the State adopt a particular regulatory scheme intrudes much more on State sovereignty than denying the State authority to regulate a certain matter. Despite some expansive language in the Court's opinion in *New York,* it seems doubtful that the Court intended to fashion a new limit on the well-established Congressional power to preempt State regulation or taxation of interstate commerce. Such a rule would necessitate the overruling or severe limitation of a good many Supreme Court precedents. E.g., *Aloha Airlines* v. *Director of Taxation of Hawaii,* 464 U.S. 7 (1983) (sustaining federal preemption of State tax on gross receipts from sale of air transportation); *Arizona Public Service Co.* v. *Snead,* 441 U.S. 141 (1979) (sustaining federal preemption of State tax on generating electricity sold out of State, where tax discriminates against out-of-State market).

Reasons Advanced for Congressional Intervention

The objections publicly made to date against State taxation of former residents' pension income seem to encompasses two strains of thought. First, only those persons who have the right to vote ought to be subject to tax; and second, those who are taxed ought to receive some benefits from the government's expenditures of tax revenues. As to the first point, there is no constitutional link between the right to vote and the duty to pay tax. Persons who lack the right to vote due to nonresidence are nonetheless properly taxable on the basis of source. Indeed, no principle is more

firmly established, both internationally and domestically, than the power of a taxing sovereign to tax income on the basis of source, regardless of the political relationship of the income earner to the taxing jurisdiction. The well recognized power that the United States and the States assert over nonresidents and foreign corporations reflects this deeply rooted rule of international and domestic law and practice.

The second line of attack—that the State of former residence does not provide benefits for the taxpayer—is also unpersuasive. It is true, of course, that a retiree who has completely severed his ties with his State of former employment may in fact receive no benefits from his tax payments *after his retirement.* But this misses the mark because it looks to the wrong point on the time continuum. Instead, the time period during which income was earned is the key. The State provided the nonresident with ample benefits—in the form of roads, police and fire protection, and other governmental services—while the income was being earned in the State. The fact that the income is taxed at a time when the nonresident is no longer receiving benefits from a State does not mean that such benefits were never received. Thus, when States tax the pension income that nonresidents have earned in the State, there is no denial of the "benefit" principle on which source taxation ultimately rests.

Moreover, it is a strange conception of fairness in taxation that would prevent a State from taxing income earned within its borders, and with respect to which the State has presumably accorded substantial benefits, merely because the State has permitted the taxpayer to defer recognition of such income. After all, deferral of recognition is a matter of legislative grace. The State could have taxed the pension rights prior to retirement, when they were earned. Had it done so, thereby recouping a fair share of the costs of government while the taxpayer was still a resident and still employed, no objection on the basis of lack of benefit or fairness could conceivably have arisen. Instead, following the federal model of pension taxation, the State deferred the tax obligation to the future, when the retiree receives pension payments. To strip the State of its power to tax such income because it has accorded the taxpayer the additional benefit of deferral cannot be supported as a matter of tax equity.

TAX POLICY CONSIDERATIONS

Proponents of a congressional ban on State taxation of nonresidents' pension income have failed to address meaningfully the real issue, i.e., what is the appropriate treatment of the taxpayer who moves interstate from the standpoint of sound tax policy? Tax policy analysis requires an inquiry into the equity, efficiency, and administrability of the tax system.

Equity and Fairness. In terms of equity, the key question is whether a retiree who moves out of State after retirement and a retiree who continues to reside in his State of employment after retirement are similarly situated. Is this a distinction that justifies differential tax treatment for these two retirees' deferred employment income? The answer is no. Both taxpayers earned income while residents of the same State, both enjoyed the same access to benefits provided by that State, and both profited by the same deferred recognition rules for retirement income. The personal choice each taxpayer makes about where to retire should not have State tax consequences in so far as the pension income already earned. The issue is not about income that either or both taxpayers will earn after retirement or after a change of residence.

But unless the former State of residence seeks to tax the pension income of former residents, there is great risk that the in-State retiree and the out-of-State retiree will have disparate tax impacts. Taxpayers who remain a resident of their State of employment after retirement will pay State income tax on their pension income when and as it is federally recognized. However, the pension income of taxpayers who relocate is often not subjected to an equivalent tax by their State of retirement.

Disparate Treatment of Public Sector and Private Sector Employees. There are published reports, including testimony at prior congressional hearings, that the States that presently seek to tax the pension income of nonresidents are much more aggressive in pursuing former State employees (including employees of political subdivisions) rather than private-sector employees. This-practice, assuming it can be documented, raises equity concerns.

Whether such a practice is equitable or fair depends upon which groups of taxpayers we consider to be similarly situated. One comparison is between State employees who retire out-of-State and State employees who remain intrastate. These groups are similarly situated, and in principle if the in-State retirees are taxed on their deferred pension income, the out-of-State retirees should be taxed likewise.

From this standpoint, the State practice of aggressive pursuit of its former employees who now reside out-of-State in laudable in terms of equity and fairness.

The other comparison is between nonresident State employees and nonresident private-sector employees, and here the practice described above raises substantial tax policy concerns. These groups are, I believe, similarly situated. Taxpayers in both groups earned income from in-State sources, the taxation of which was deferred. In both cases, taxpayers who benefitted from deferral should have had the expectation that the State would tax the pension income later, upon receipt. Moreover, there is no statutory basis for the States to discriminate between these two groups. State income tax statutes generally impose tax on the income of nonresidents from all sources within the State, regardless of whether the source is public or private. If State tax authorities make no consistent efforts to tax the pension income of private-sector former residents, this group receives the benefit of de facto tax forgiveness.

State tax administrators may attempt to justify the differential treatment by pointing out enforcement is easier for former State employees because the State itself pays the pension and has all the relevant employment records—no information need be acquired from third-party employers. This explanation may be satisfactory as a short-term, temporary expedient; it may not be feasible to require that a State immediately enforce its tax code against both groups. In my opinion, however, a long-term strategy of taxing the pension income of nonresident former State employees while forgiving tax on the pension income of nonresident private sector employees is unfair to the State employees.

Double Taxation and Credits. When the taxpayer retires to a State that taxes the pension income, the possibility of double taxation arises. The widespread availability of a tax credit substantially solves the problem of an unfairly high tax burden stemming from two States taxing the same pension income. All States with income taxes presently provide credits for residents who earn income from sources in other States. Different States use different formulas for calculating the credit, and sometimes the credit will be less than the tax paid to the source State.

While the granting of credits is not mandatory under the due process clause, it seems likely to continue for the foreseeable future. Moreover, an argument can be made that the negative commerce clause requires the granting of tax credits for residents' source income from other States. If the receipt of pension income from work in another State is within the scope of interstate commerce, the Supreme Court cases that apply the "internal consistency" doctrine suggest that a credit is necessary in order to avoid an undue burden on interstate commerce. See Hellerstein, Is *"Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation,* 87 Mich. L. Rev. 138 (1988).

Efficiency. Efficiency is offended if the pension income of retirees who move interstate escapes the tax imposed on retirees who chose continuing residence. The concern, an issue of tax neutrality, is whether the State income tax system causes retirees to alter their behavior with respect to their decision where to live. Here efficiency analysis dovetails with equity. If the State of retirement fully taxes the retirement income of the new resident, there is no efficiency problem. But often this will not be the case, and for reasons of efficiency as well as equity the tax system should not influence a retired employee's decision as to where to retire. It should not penalize retirees who elect to stay a resident, nor should it create a tax windfall for those who load the moving van.

Practical Difficulties

The conclusion that there is no theoretical justification for prohibiting States from taxing nonresidents pension income earned within their borders does not mean that legislation barring States from doing so is necessarily bad policy. There are practical problems raised by State taxation of nonresident pension income that may nevertheless justify the proposed congressional restraint.

Distinguishing taxable deferred compensation from nontaxable deferred investment income. Pension income reflects more than deferred compensation. Retirement accounts start with initial or periodic employer or taxpayer contributions, which purely constitute deferred compensation, but over time investment income, consisting of interest, dividends, and the like, accumulates on the taxpayer's deferred compensation. For many retirees, in monetary amount the accumulated investment income is much larger than the sum of the contributions reflecting deferred compensation due to the time value of money and the long time accumulations accrue for retirement plans that are funded for decades prior to retirement. Accumulated investment income in tax-qualified retirement plans is tax deferred, both at the federal and State tax level, just as is the deferred compensation itself.

This fact that pension payments include deferred compensation components and investment income components creates a serious practical complication in State taxation of nonresident pension income. For while States clearly possess the power to tax income from personal services performed by nonresidents in the State as well as investment income earned by residents, they clearly lack the power to tax investment income earned by nonresidents unless it has an in-State source. See *Molter v. Department of Treasury*, 505 N.W.2d 244 (Mich. 1993) (former resident not taxable on interest accrued on contributions to qualified deferred compensation plan).

Because States generally lack the constitutional power to tax the portion of a former resident's pension income that reflects accumulations after the taxpayer's change of residence, States must limit their taxation of nonresident pension income to the deferred employment income and the income accumulated prior to the retiree's change of residence. As a practical matter, it may be difficult, if not impossible, for a State (or for an employer with State withholding tax obligations) to determine, on a pension-check-by-pension-check basis, what proportion of the payment reflects deferred payment for services rendered in the State and what proportion represents investment income that accrued while the taxpayer was a nonresident of the State.

Deferred Compensation involving more than two States. Americans are very mobile, now more than ever. Often more than two States will have plausible claims to a taxpayer's pension income due to the fact that the taxpayer has worked in more than one State prior to retirement or has earned income in a State other than his State of residence. In such multistate situations, jurisdictional tax claims may proliferate. Each State is obligated to limit its pension tax to deferred compensation from services performed in the taxing State or while the retiree was a resident. And for investment income accumulating in the retirement plan, each State is obligated to exclude from its pension tax any investment income accumulated while the taxpayer was a nonresident of the taxing State. With these two obligations coupled together, the problems of implementing a constitutionally acceptable nonresident pension tax may be insuperable.

Possible State Responses to Congressional Legislation

If Congress were to bar State taxation of nonresident pension income, the States will not necessarily roll over and play dead. There are several different approaches they could adopt with respect to deferred pension income. Each approach raises tax policy concerns, and some present constitutional issues as well.

State repeal of deferred recognition generally. One reaction States may take is simply to uncouple their taxing regimes from the federal model and end deferral of income paid into qualified pension plans and the like in order to preserve their revenue bases. The States are constitutionally free to take such action, and a number of States have elected not to follow federal rules for deferring retirement income. For example, Georgia for a number of years taxed employee contributions to retirement plans and did not allow a full deduction for IRAs. Although Georgia presently tracks the federal system, it could choose again to curtail deferral.

If congressional action prompts States to repeal deferred recognition, nonresident retirees gain but a Pyrrhic victory. In terms of tax policy, however, State repeal of deferral would not necessarily be bad. With continuing residents and former residents treated identically, equity and efficiency concerns are completely satisfied. But this outcome does have a cost. It adds complexity for taxpayers when they must report deferred income to their State but not to the federal government. This adds work for preparing tax returns not only when the taxpayer is working, earning the income, but also during retirement, when the taxpayer will have a basis in the retirement plan for State income tax purposes but not for federal purposes.

State repeal of deferred recognition for nonresidents. Alternatively, States might seek to preserve tax deferral for continuing residents, but deny it to those departing retirees who are on the eve of obtaining congressional immunity. States may try to tax deferred personal service income of departing residents, making the change of residence an event that triggers recognition of income. Such an approach could also extend to nonresidents who work within the State, with cessation of in-State employment serving as the tax trigger. The tax code of at least one State—California—already appears to call for such treatment for departing residents. Cal. Rev. & Tax. Code § 17554 (West 1994).

Such a strategy, however, creates thorny federal constitutional problems. The essential claim is that the statutory denial of nonrecognition treatment discriminates against nonresidents in violation of the privileges and immunities clause. The State's response would be that there are compelling "independent" reasons for denying tax deferral on pension income for departing residents. Specifically, the State would contend that the denial of deferral to departing residents is a rough but ad-

ministratively feasible means of achieving equality between residents and nonresidents. This argument may be strengthened substantially were Congress to prohibit States from taxing nonresidents' pension income. Then the States would face a statutory bar on their jurisdiction, rather than substantial administrative problems which might in fact be capable of solution.

MERITS OF DIFFERENT APPROACHES FOR FEDERAL LEGISLATION

Two of the bills, H.R. 371 and H.R. 394, simply prohibit all State taxation of nonresident pension income. H.R. 744, in contrast, prohibits the taxation of pension income received in the form of annuities with a payment period either for life or for a fixed period of at least 10 years. Lump-sum payments and shorter term annuities remain taxable, subject to a one-time $25,000 exemption. There are three reasons why the differential treatment proposed in H.R. 744 may be appropriate. First, this treatment may serve to curtail tax avoidance by highly compensated individuals. If States cannot tax large lump-sum distributions or short-term periodic payments from qualified plans, then taxpayers who plan to retire to other States in the near future might convert ordinary compensation to retirement income. Receiving the deferred compensation after the date of change in residence would strip the State of taxing jurisdiction. While such tax planning is still possible to some extent under voluntary retirement plans even if the taxpayer must select a long-term annuity, abuses are much less likely if the taxpayer must forgo what would have been ordinary compensation for a substantial time period.

A second and related potential justification for the differential treatment is the taxpayer's ability to pay, or need. A retiree who elects a long-term annuity arguably is more likely to need that income for living expenses than a retiree who "cashes out" of a plan quickly. But the relationship between ability to pay and length of payout may be rather indirect. Some well-to-do retirees will receive high payments in the form of long-term annuities, and some lower-income retirees will choose lump-sum settlements or short-term annuities.

If the differential treatment is justified either on the basis of minimizing tax avoidance by highly compensated individuals or on the basis of probable need of taxpayers receiving long-term annuity payments, a different strategy is desirable. It makes more sense to tackle these issues directly by utilizing an annual exemption, such as $20,000 or $30,000, that shelters pension income regardless of form or length of the pay-out period.

Third, the practical difficulties of determining how much of each annuity payment is properly taxable may justify limiting the exemption to long-term annuities. Each annuity payment received by a former resident has two components: deferred compensation, which in principle is taxable by the State of former residence, and investment income, which is not taxable to the extent it accrued after the date of change in residence. With longer annuity pay-out periods, the ratio of investment income to deferred compensation income is higher. I am not persuaded, however, that the computational difficulties in making the proper allocations are markedly greater for such long-term annuities than for short-term (e.g., 3 year) annuities. For a single lump-sum payment, computing the amount of deferred compensation income may be simpler, but even then allocation is necessary if the payment includes investment income that accrues after the date of change in residence.

These three reasons make the lines drawn between taxable pension income and nontaxable pension income (whether under H.R. 744 or, as an alternative, an across-the-board annual exemption) constitutionally defensible, in terms of due process and equal protection. Nevertheless, there are substantial downsides. First, the line drawing is complicated. Both nonresident taxpayers and State tax administrators will have to learn and apply the rules. There is some risk that many nonresident taxpayers, in their tax planning, will fail to understand the tax implications of how they choose to receive money from their pension plans. Thus, for reasons of policy—tax simplification—a clear all-or-nothing rule is desirable.

A second downside is that partial exemption of pension income is only a partial solution to the real problem. If Congress acts at all, the reason for intervention should be that States are unable to overcome the practical problems of tax administration in the area. If the States are permitted to tax some but not all of the pension income of their former residents, they will still have to solve the same significant hurdles of distinguishing deferred income which they may tax from investment and interest income which they may not tax. In addition, there will still be the complicated cases involving more than two States to resolve. Thus, although the proposed lines to be drawn between taxable and nontaxable pension income reduce the number of cases where the States must solve severe administrative difficulties, many troublesome cases will remain.

I would also note, in passing, that if Congress acts because it is persuaded that it is unfair or inequitable for States to tax the pension income of its former residents, because they no longer receive benefits from their State of former residence or for some other reason (arguments which I reject, as stated above), a total exemption also seems merited. If in principle such taxation is unfair or oppressive, the amount of income at issue and the timing of its receipt should not matter.

In conclusion, the considerations that have occurred to me do not clearly illuminate the best approach. The line drawing between taxable and shielded pension income is in part an attempt to intrude on State authority no more than is necessary. And, as I indicate above, there are plausible reasons for permitting States to tax some but not all of the pension income received by their former residents from qualified plans. Nevertheless, on balance, if Congress acts I recommend a bright-line rule, such as the one embodied in H.R. 394, that exempts all "qualified plan" pension income received by former residents from State taxation. To me, the virtues of a simple, clear rule, coupled with the purpose of restraining the States from trying to solve administrative problems that are probably intractable, outweigh the other considerations.

Mr. GEKAS. Yes. Noting the presence of Senator Reid of Nevada, we will invite him to join you at the witness table, allow him to make his statement, and then cross-examine both of you at the same time.

We welcome you, Senator.

STATEMENT OF HON. HARRY REID, A SENATOR IN CONGRESS FROM THE STATE OF NEVADA

Mr. REID. I apologize for being late.

Mr. GEKAS. You were in nuclear waste land, we heard.

Mr. REID. Yes, and two of my favorite subjects, source tax and nuclear waste, and, as a result of that, I rushed back after the nuclear waste hearing and missed a vote, which we don't do often around here, but source tax is worth it, so I am happy to be here.

Mr. GEKAS. Please proceed.

Mr. REID. I would ask that the full statement be made part of the record.

Mr. GEKAS. Without objection.

Mr. REID. Mr. Chairman, members of the committee, this, as you know, is an issue that is important to me and I think the people of this country. This source tax repeal has passed the Senate on three separate occasions, it has passed the House on one occasion, and, as you will recall, last year in the waning hours of the session, Senator Malcolm Wallop from Wyoming killed this in the Senate.

We have a procedure there that allows in the final hours of a session that someone can put a hold on a bill, and, as a result of doing that, you can't get unanimous consent to get it passed, and as a result of this the bill was killed. It should already be the law.

The source tax issue was brought to my attention a number of years ago by a Carson City, NV, based retirees group that you are later going to hear from today. This group, called RESIST, was founded in 1988 to fight the source tax. In less than 4 years RESIST's membership has grown to tens of thousands of members, with members from every State in the Union. It is nonprofit. It is a grassroots organization. It operates entirely on volunteers. There are no salaries paid to anyone.

The credibility of this group has convinced other long established organizations such as the National Association of Retired Federal Employees, the Retired Officers Association, American Payroll Association, Association of Private Pension Welfare Plans, and the

Profit-Sharing Council to make a commitment to prohibition of the source tax on pension income.

Furthermore, Congresswoman Vucanovich's and my legislation have now gained exclusive support from several organizations such as ERIC, which is the ERISA Industrial Committee. Its president, Mark Ugoretz, states—and I quote—that they reject other proposals that cap pension income exempted from State source taxes or allow States to tax pensions from nonqualified plans.

Similarly, the American Council of Life Insurance has stated that our legislation contains the only proposal they can support.

Legislation that limits income level and type of pension plans that are taxed do not address a basic flaw of the source tax. Huge numbers of retirees' benefits exceed the cap or nonqualified plans. The other legislative proposals do nothing for this large number of employees.

Mr. Chairman, I would hope that you would ask Mr. Hoffman about some of the examples of just some of the real tragedies that involve this. The States which collect this source tax do it without any regard to how much income the people have. We have people who, literally, it is a matter of life and death, and Mr. Hoffman can tell you some of those. My statement has in it an example of a woman from Fallon, NV, who simply was caught between a rock and a hard place when this collection was initiated.

This legislation, Mr. Chairman, will not cost the Federal Government a penny. In fact, the Federal Government will make money if this legislation passes. The reason for that is that you can have an offset for the Federal tax that you pay from—the State tax you pay from your Federal income tax. There would be less State taxes paid. Therefore, the Federal Government would make additional money. It wouldn't be a lot of money, but this is a net gain to the Federal Treasury.

I appreciate the courtesy of allowing me to appear out of order.

[The prepared statement of Mr. Reid follows:]

Prepared Statement of Hon. Harry Reid, a Senator in Congress From the State of Nevada

I would like to thank the Chairman and the Members of the Subcommittee for the opportunity to appear before them today in support of H.R. 394.

As you know, for the past four years, I have sponsored legislation to prohibit states from taxing the income of non-residents. This year, I have again reintroduced legislation to stop this unfair taxation. I introduced similar legislation that passed the House and the Senate in the 103rd Congress and passed the Senate twice in the 102nd.

Today, many retirees are forced to pay taxes to states where they do not reside. The retirees pay taxes on pensions drawn in the state where they spent their working years, despite the fact that they no longer live in that state. As I have said many times before, this is taxation without representation. Retirees are no longer participating in the state's medical assistance programs or senior centers, nor do they use the roads or public parks that these taxes are helping to fund. Most importantly, they are not allowed to vote in their former state of residence—yet they still pay taxes to these states.

I have told a story which illustrates the inequity of the practice of source taxing pension incomes on nonresidents. The story is about a Nevada citizen, but it could be happening in any state.

There is an older woman who lives in Fallon, Nevada and has an annual income of between $12,000 and $13,000 a year. She is not rich, but she is surviving. One day the mail carrier delivers a notice from California that says she owes taxes on her pension income from California, plus the penalties and interest on those taxes. She can not believe it but, being an honest person, she tells California that she has

never paid these taxes in the past and asks why she is being assessed at this time. To make a long story short, the California Franchise Tax Board went back to 1978 and calculated her tax debt to be about $6,000. This woman's income is only $12,000 a year.

These problems are compounded when more than one state seeks to tax the same pension income. Residence in a number of states during the working years can lead to a division of pension income, the filing of separate tax returns for each state, and the payment of taxes in each state. Furthermore, the administrative burden on corporations to keep track of employees who have worked in several states over the years can be overwhelming. Therefore, the existence of a state policy of taxing the pension income of nonresidents may also be a disincentive for corporate headquarters to locate within the state. Corporate executives would also be dissuaded from incorporating in these states because it is expected that they will retire outside the state.

The source tax issue was brought to my attention several years ago by members of the Carson City, Nevada-based Retirees to Eliminate State Income Source Tax, known as RESIST, which was founded in 1988 to fight the source tax. In less than 4 years, RESIST membership has grown to tens of thousands of members. It includes members of every state of the Union. It is truly a nonprofit, grass roots organization. It operates entirely on the work of volunteers. No members are salaried.

The credibility of this group has convinced other long established organizations, such as the National Association of Retired Federal Employees (NARFE), the Retired Officers Association, the American Payroll Association, Association of Private Pension and Welfare Plans, and the Profit Sharing Council to make a commitment to the prohibition of the source tax on pension income.

Furthermore, Congresswoman Vucanovich's and my legislation has now gained exclusive support from several organizations, such as ERIC, the ERISA Industry Committee. ERIC's President, Mark Ugoretz stated that they "reject other proposals that cap pension income exempted from state source taxes or allow states to tax pensions from nonqualified plans." Similarly, the American Council of Life Insurance (ACLI) has stated that our legislation contains the only proposal they can support. Legislation that limits the income level and type of pension plans that are taxed do not address a basic flaw of the source tax—huge numbers of retirees' benefits exceed the caps or are in nonqualified plans. These other legislative proposals do nothing for this large number of retirees.

I think it is important to highlight the fact that this legislation has no cost to the federal government. In fact, it could possibly enhance federal revenue because of the state tax deduction.

Initially, this issue affected mostly retired government employees because of easy access to their records. However, as economic times become tougher, and state budgets are straining for additional revenues, the source tax is becoming an ever more popular revenue source. State budgets are experiencing economic hard times. It will not take long for states to realize that taxing someone from another state is an easy way to increase revenues without paying the political price. In other words, unless mine and Congresswoman Vucanovich's legislation is passed you can be sure that more and more states will begin to impose this unfair tax for which no one is accountable.

Mr. GEKAS. We thank the Senator.

Mrs. Vucanovich and Mr. Stump adequately presented the case for the border States to California. You mentioned in part of your testimony that perhaps it is an anomaly to talk about caps or some portion of the pension being subject to the tax while others are not. It is a question in our minds, or getting to be, that it is either all or nothing.

Mr. REID. I would agree, Mr. Chairman.

Mr. GEKAS. Otherwise you don't address the basic issue.

Professor Smith, what do you think about that, is it impractical and if it does have some other legal problems, we shouldn't be dividing the question by even discussing caps; is that correct?

Mr. SMITH. I think so. The caps to me make sense only if the prime policy concern is for retired persons who have a relatively modest retirement income and who are hurt the hardest by it.

But as I listen to the testimony and as I have thought it through, the practical difficulties in administering the tax fairly bear upon all former residents who are in another State. The measurement problems are just as severe for those who earn annual retirement income in excess of the $30,000 annual exemption that was in the bill passed by the House of Representatives last year.

So it is my belief that if Congress should decide to intervene, dollar-amount limitations, either imposed upon annuities or upon lump sum distributions, are not the best way to go.

Mr. GEKAS. Also, Senator Reid mentioned that perhaps there would be a retiree living in his jurisdiction who might have one source of income which is the pension check from California. That would imply that California might not even have a minimum above which only would there be taxation for indigent or disadvantaged or low-income people who would be rendered low-income even with a pension check coming monthly. Is that a consideration we ought to have on our table?

Mr. SMITH. In my mind, not a very substantial one because California would have to give to the Nevada retiree the same personal exemptions and credits that it gives to its in-State retirees.

Mr. GEKAS. Do you know that for a fact that—first of all, we don't know if California does have this minimum—I suspect they do—secondly, whether they apply that to pensioners. We don't know that for sure, do we?

Mr. SMITH. I do not know what their present policy or nonresident forms provide, but I am strongly of the opinion that, constitutionally under the privileges and immunities clause, they would have to give nonresident taxpayers the same exemption structure and the same progressive rate structure as they do to the in-State retirees.

Mr. GEKAS. All right. I have no further questions.

The gentleman from Rhode Island.

Mr. REED. Thank you, Mr. Chairman.

Senator, you said last year that the measure failed at the very end of session. Could you tell us what caused the failure, any specific reasons?

Mr. REID. You don't have to have a reason. Senator Wallop said, it was my understanding, that he was concerned about a large company and how its retirees would be treated.

Mr. REED. That might go to my second question, Senator, that that there were two issues that have been—several issues, but two prominent issues. One is a cap, which Professor Smith has talked about. The other is the inclusion of nonqualified pension plans.

One concern would be, some of these nonqualified pension plans, literally individualized deals that an executive might make or some prominent member of a company makes for a great deal of income that is deferred, it is not a plan that applies to everyone. It is not—as you well know, it is not something that is a routine pension situation.

I am wondering what your attitude or feeling is with respect to those types of plans and being able literally to escape State taxation by deferring income to a pension plan, then leaving the State.

Mr. REID. Congressman, this is, in my mind, typical of what we worry about back here and that we have become so concerned with

individual rights that we lose sight of what are the rights of society.

There may be particular instances where somebody, in effect, does something that borders on being dishonest, and I of course would hope that there would be a way of making sure that they pay fair tax on that. But we are talking about hundreds of thousands, if not millions, of people who are being taxed. They don't use any of the public facilities in a State, they don't drive their highways, they don't use any of their medical facilities, they use none of their recreational facilities, and they are asked to pay an income tax from the simple twist of fate that they worked there for part of the time.

It is so unfair that not only do they collect taxes on the income from the pension but they collect taxes from other income that these people have. This is the rankest form of taxation without representation. And, Congressman Reed, my concern is—it sounds like I am talking to myself—my concern——

Mr. REED. You spell it wrong.

Mr. REID. My concern is that I think we should, in my opinion, just pass a law to prohibit this. If there are specific instances where people are cheating, are being dishonest, then let's deal with that; the two money committees can do that, Finance and Ways and Means.

Mr. REED. I am not suggesting anyone is doing anything wrong. What I am suggesting is that someone legally could, to properly avoid taxes in a State, simply take deferred compensation in some type of unqualified plan with substantial amounts of moneys with the idea that within 1, 2, 3, or 6 years they would be in another State which would not have any taxes. I think that is something we should at least consider.

Mr. REID. I am sure we should consider it. I don't know enough about how to handle that.

Mr. REED. Professor Smith, you might have a thought on that in that regard.

Mr. SMITH. On that point, I recommend that Federal legislation not shelter distributions made from nonqualified plans. Virtually all Americans are eligible for, or in fact participate in, some type of qualified plan, whether it is through an employer, whether it is an IRA, or whether it is something else. The potential for tax avoidance by highly compensated individuals who funnel amounts into nonqualified plans in the last years before retirement is simply too great of a risk.

By definition, nonqualification generally means there aren't dollar caps to how much can be deferred, so that such individuals could consciously forgo what normally would be regular salary or regular bonuses, electing to put them into a nonqualified plan or nonqualified trust mechanism and receive it later on. Those individuals, I would think, would be sufficiently sheltered by Federal legislation that exempts their normal qualified plan, whatever that happens to be.

Mr. REED. Thank you, Professor.

Let me address one other issue which you alluded to in your testimony. You said that States could in fact—and we all know what pressure they are under in terms of their budget—react to that by

simply accelerating the recognition of this income. How likely do you think that would be—you are someone who is looking at State tax policy on a constant basis—that they would essentially react to our legislation by recognizing the income as it is earned and not allowing deferral?

Mr. SMITH. I find that difficult to predict. A State, in order for it to make sense, from its own cost-benefit analysis, will have to conclude that many more of its employees are retiring out of State than are coming in. Only then will the State see a really substantial cash drain from simply living with the Federal legislation and not modifying their State tax code to require reporting immediately.

If one or several States did make that change, I don't know that Congress necessarily should believe, if several States do that, that it made the wrong policy decision.

True, it is a little more work for taxpayers in those States, who then have to, for State income tax purposes, add to their Federal adjusted gross income the amount of their employer or employee contributions to the pension plan, each time they file a yearly return while they are working. But it can be done.

In Georgia, where I live, when I first moved there, Georgia did not follow Federal deferral rules for the State teachers retirement plan that I am in, and they had a smaller IRA deduction. And so for tax returns for those years you did have to do a little bit more work for the State tax return, but not overwhelmingly so.

Mr. REED. Thank you.

Mr. Chairman, I don't have another question, but I would like to raise one issue. That is, we should consider whether this might in some way constitute an unfunded mandate.

Mr. GEKAS. Yes, I have that in mind, and we will consider that in the premarkup consideration of this legislation.

Mr. REED. Thank you, Mr. Chairman.

Mr. GEKAS. The gentleman from South Carolina, Mr. Inglis.

Mr. INGLIS. Thank you, Mr. Chairman.

Professor Smith, I was interested in your observation that—did I get this down right?—that the two bases of—basis I think, isn't it? About which a State may tax residents or nonresidents. One is the source. Is that correct? And the other was residence? Is that right?

Mr. SMITH. Right.

Mr. INGLIS. So let me make sure I have got this straight. If I live in South Carolina but work in Georgia, the State of South Carolina may tax my income because——

Mr. SMITH. Because you are a South Carolina resident. But the State of Georgia also may do that because they are the source State where your services are performed where you work. Then typically, South Carolina, when you file a resident tax return, will give you a credit for the taxes paid to Georgia.

Mr. INGLIS. That is right. And if I own property in North Carolina, living in South Carolina, then obviously the State of North Carolina may tax the real estate because it is resident in North Carolina, but I am not resident there; right?

Mr. SMITH. Correct. And assuming that it is rental property, they could also tax your North Carolina income that represents the rents from that property.

Mr. INGLIS. Correct. However, if I simply own property in North Carolina, am resident in South Carolina, but work in Georgia, North Carolina cannot tax the income from Georgia. They have no contact with the income.

Mr. SMITH. Right.

Mr. INGLIS. So if I, by similar logic, move from California and no longer have any contacts with that State, how it is that they would assert the capacity to tax me. Isn't it the same thing as me owning that property in North Carolina but not being there?

Actually, no, it is not even that. It is that I have completely vacated California. I have no property. I have no income. I have no contact with the State. I am wondering. You asserted that it is constitutionally correct for them, I think we should do this legislation regardless, and that is probably your point, too, regardless of whether it is constitutional or not. I think is Mr. Scott's point earlier. Regardless of whether it is constitutional or not, we should do it.

Mr. SCOTT. It is constitutional, and therefore we may do it.

Mr. INGLIS. That is the point. That is the point. In other words, that California may be able to do this, may be able to do what they are doing, but for public policy reasons we are exercising our constitutional authority, which you have just asserted that we have at the Federal level, may choose to eliminate that capacity to do this.

I am really sort of stuck on whether they have got the constitutional ability to do it, to do what they are doing, that California has the ability.

Mr. SMITH. I believe your hypothetical is distinguishable in this sense. The property you mentioned in North Carolina is presumably property you purchased with assets or other income that is unconnected to Georgia, and, as you rightly say, Georgia has nothing whatsoever to do with it.

This particular situation, where the situs of property is clearly outside of the source State, is different than the situation where we are talking about income that was definitely earned in the source State, where the person lived and worked. And, later on, that income is now in a particular deposit or a fund, and the person moves to another State and with them somehow managed to move the account.

Here, for the Georgia-North Carolina situation, you didn't say that the property in North Carolina happens to be proceeds of income that was earned in Georgia and Georgia never taxed that but deferred it with the expectation that later on a tax would be due when that income was recognized federally——

Mr. REID. Could I interrupt? My beeper went off, and I already missed one vote. Could I be excused?

Mr. GEKAS. Obey the beeper.

Mr. REID. One thing. I don't have the latest count. We have had a significant number of California Members of Congress who support this legislation. So we are not here beating up on California. Members of the California delegation understand how unfair it is.

Mr. GEKAS. We thank you, Senator, for taking time to present yourself here.

Mr. REID. Thank you. Pardon me.

Mr. INGLIS. The red light is on. I think my time is up.

Mr. GEKAS. We can extend it if you want, but think about something else you might want to ask and then avoid the temptation.

We turn to the gentleman from Virginia.

Mr. SCOTT. Thank you, Mr. Chairman.

I wanted to qualify one of the suggestions from the gentleman from South Carolina. We would consider passing this legislation because we think it is constitutional, not irregardless of its constitutionality. If it wasn't constitutional I would hope that we would refrain, whatever we thought about the practical aspects of it.

Speaking from a practical aspect, who gets hit with this source tax on an ongoing basis other than some hapless soul who gets tripped up after the 4 or 5 years, and they come after 3, 4, 5 years of back taxes? Who actually pays this source tax voluntarily today?

Mr. SMITH. This is a major problem. From the research I have done, I believe it simply happens to be those who are unlucky, who typically are State employees whose records are easily available to the source State, or perhaps those who are honest and realize they have an obligation to continue to file nonresident tax returns for States such as California.

Mr. SCOTT. These honest people would probably be those who have an income tax in their State they would have to pay. So it is either pay it to California or pay it at home, because they are going to get a tax credit for it, so it didn't make any difference.

But those in Arizona or Nevada, I think they have no income tax. The only people that get hit with it are those who have State checks where the State actually has the record and can withhold and enforce their source tax.

Mr. SMITH. As a practical matter, that is what I believe is happening now, although I have not personally done empirical research.

Mr. SCOTT. Although theoretically the limit doesn't make sense, either you want to do it or you don't. If you had a limit—maybe not $30,000, maybe $100,000—people making more than that in pension income can in fact do the paperwork and comply, but those regular employees, it would be just too complicated to figure out where you got the money.

So if had you a limit of over $100,000, wouldn't it be possible to do the work and also catch the people that are doing these large deals where they defer massive amounts of income into a time where they are in a nontax, non-income-tax State? If had you a limit of $100,000, could that work?

Mr. SMITH. I think a very high limit like that would substantially solve all of the problems of retirees, and, as you say, those who have income of that amount clearly can or should be able to afford a tax accountant or other expert to help sort out their tax liabilities, even if several different States have a claim to tax their income.

Mr. SCOTT. Thank you.

Let me kind of switch subjects. The form of the money I think gets complicated. If you have a deferred income versus pension in-

come, would they be treated different in a source tax situation, in an IRA that you roll over? Can you say a little bit about how we get caught up in the form of the money?

For example, if you have a pension, an IRA for instance, move out shortly thereafter and 20 years later start withdrawing from the IRA, it is your suggestion that the increase in value of the IRA would not be taxable, just the original $2,000 that you put in?

Mr. SMITH. Yes. I think clearly under the due process clause, once the person has become a nonresident and once it is clear, as in this situation, that the plan is no longer administered or located in the source State, at that point in time the source State has lost all of its jurisdictional contact with both the taxpayer and the money and has only that piece of the pie that represents the amount of income put into the IRA or other plan while the person was in the State.

In the situation that you gave, yes, if they moved and it was two decades later when they began taking IRA funds out, they would at that point in time, as a matter of principle, be required to report just a fraction. With the time value of money, the fraction might be considerably less than half of their IRA annuity payments or their IRA lump sum distribution. In my mind, the complexity of doing that computation properly so that the source State does not overreach but precisely calculates what it should tax is one of the prime reasons why Congress should act.

Mr. SCOTT. Could I ask one more question, Mr. Chairman?

Mr. GEKAS. Yes, without objection.

Mr. SCOTT. Thank you.

What would happen if you were to sell your pension?

Mr. GEKAS. What was the question?

Mr. SCOTT. What would happen if you were to sell your pension? Can you sell a pension?

Mr. SMITH. I am really not positive. I am not a specialist in pension matters generally. I deal with income tax matters and I don't really know the answer to that.

Mr. SCOTT. Thank you.

Mr. GEKAS. We note the presence of the gentleman from Ohio, Mr. Chabot, and turn to him for any questions that he might wish to present.

Mr. CHABOT. Thank you, Mr. Chairman.

I guess just a quick preliminary observation I would make. It would seem to me if some States, kept their taxes at reasonable levels and didn't have them go so high, perhaps residents wouldn't flee the States to begin with and they wouldn't have to go back and try to collect them again. That is just a preliminary observation on my part.

How many States, Professor, if you know, have source taxes, tax where they go after folks after they have left the States? Is it a lot, or do you have a list available?

Mr. SMITH. Some of the other witnesses may have a list. My recollection from materials that I have studied is that presently only a handful, maybe seven or eight, have any announced policy of requiring filing by nonresidents.

A point that I would make, though, is that most States with broad-based income taxes have general language in their tax codes

that requires that nonresidents file tax returns for income earned within the State. Such general language could be interpreted by States such as Georgia, that presently don't have started positions as requiring source taxes for nonresidents who previously worked within the State.

So that as it stands now many States, as an administrative matter, could become more active in the area probably without amending their tax codes.

Mr. CHABOT. Also, our colleague, Representative Vucanovich, had mentioned earlier that the State of Nevada has passed legislation to prevent California from imposing this tax and the tension, for example, that's created between these two States. Might that be an independent reason for Congress to act because we in this case have two States that are at odds on this issue.

Mr. SMITH. It may be. You are seeing a situation where those States and others are perhaps not at war but are yet having significant friction due to those particular acts. I think that their constitutionality is doubtful under the full faith and credit clause of the Constitution. But, even so, as you pointed out, there is a significant amount of friction that may be solved by congressional action.

Mr. CHABOT. My final question is: If States want to tax pension benefits, I guess they could. Those States could tax that money while it is earned. But if they did, those people who are voters could vote them out of office.

On the other hand, if you tax somebody after they have left your State, they can no longer vote against you. So perhaps it doesn't matter as much, and maybe that is why they have chosen to take this route.

I appreciate your testimony here this morning and yield back the balance of my time.

Mr. GEKAS. All right. The subcommittee thanks the professor for appearing and presenting his testimony, and we will count on him as we move toward the final production of legislation for any further inquiries that we might want to make of him.

Mr. SMITH. Thank you very much, Mr. Chairman and members of the subcommittee.

Mr. GEKAS. Thank you. We now invite William Hoffman, president of RESIST, to the witness table; with Christopher Farrell of NARFE, the National Association of Retired Federal Employees; Harley Duncan, executive director of the Federation of Tax Administrators; Randall Johnson, director of benefits planning at Motorola, on behalf of several entities also interested in this subject.

What we will do, without objection, is invoke the 5-minute rule for the testimony to be offered by each. We will begin in the order in which their names were announced and then reserve questioning until all have testified.

Mr. Hoffman will begin.

STATEMENT OF WILLIAM C. HOFFMAN, PRESIDENT, RETIREES TO ELIMINATE STATE INCOME SOURCE TAX (RESIST)

Mr. HOFFMAN. Good morning. I would like to thank the chairman and the committee for hearing the source tax issue and inviting me to speak.

My name is Bill Hoffman. I am president of RESIST of America, a nonprofit corporation whose only goal is to end the tax on nonresident pensions by the States. We are a grassroots organization that operates entirely through unpaid volunteers. We are not, however, against fair taxation with representation. As Senator Reid said, we have been trying to pass legislation for 8 years. It has passed the Senate three times and the House once, unfortunately not at the same time.

Taxation of nonresident pension by the States affects every American at every income level and is a totally bipartisan issue. Our senior population faces many problems and uncertainties as they grow older, including failing health and shrinking financial resources. The ignoble practice by the States of taxing retirees on nonresident pensions adds significantly to their burdens.

Most retirees were totally unaware that their former States would tax them for the rest of their lives without giving any benefits or rights. Even worse, a State like California mailed letters in the seventies to retirees telling them they did not owe this tax, and then they had the nerve to go back to these same retirees and say: We made a mistake, and you not only owe us the taxes but 55 percent in penalties plus daily interest.

Now, this tax really hits retirees hard. I have included in my written testimony five examples of the thousands we have received about real people affected by this unfair tax. An example involving a family who was told they didn't have to pay the nonresident tax and then wound up having their pension check garnished; one involving double taxation through intimidation, which happens quite a bit, of true double taxation which the States say never happens; one that shows how States even go after retirees with low income; and an example, finally, of how uncontrolled and unsympathetic tax agencies can be.

Our current bills, unfortunately, do not provide a solution for retirees that are now faced with a huge nonresident tax bill. Adding an amnesty clause in the current bill would solve this problem. I would encourage Congress to consider this addition but without jeopardizing the basic bill.

Now, this tax also hits companies hard. Under present law, companies are required to keep extensive records of present and former employees that have vested in a pension plan. These records are expensive and difficult, if not impossible, to implement.

In my written testimony I reviewed a paper and tax notes by Walter Hellerstein and James Charles Smith you just heard from, both professors of law at the University of Georgia. There are comments in the written testimony on both their theoretical and practical analysis.

The following points should be addressed now, however. Hellerstein and Smith claim we would have a pyrrhic victory for nonresidents if our bill passed because the States would either stop deferring the tax or would collect it when the retiree left the State.

Now, we don't believe the States will stop deferring the tax because they can't predict which retirees will remain in the State. If they stop deferring the tax, they can probably not tax resident pensions.

If the States collect the tax when the retiree leaves the State, there should be requirements put on them. One, they should have informed those in the pension plan about their State's nonresident tax policy when contributions are made to the plan, not years later. If retirees are not informed, they should not be taxed. Second, they should use a fair settlement option similar to a 10-year average plan.

Now, we hope States will not make these changes, but if they do, it is still better than being taxed for the rest of your life without representation.

In addition to the Federal legislation, we have tried to work this problem at the State level, as some Congressmen and AARP have suggested. The written testimony describes our efforts toward this goal in detail. It was generally a failure, except for New Jersey and Iowa. Both States have repealed their nonresident tax on pensions and thus removed themselves from Bob Brinker's "Hall of Shame." He is a host of a weekly radio show, "Money Talks," and mentions this every week.

We have stopgap measures in nine States, some with income tax, to prevent the seizure of property for the collection of these taxes. A number of other States are considering similar legislation. An economic war between the States has begun.

When State borders are crossed, individual rights must be protected by the Federal Government. Therefore, with the millions of people in our coalition, we urge you to pass H.R. 394 or similar legislation, a bipartisan bill with little cost impact on either the Federal Government or the States. Stop taxation without representation, an issue that caused our revolution. Stop this injustice to seniors and future seniors. We are not asking for money, only justice.

Thank you for a your attention. I will be pleased to answer questions.

I would like to make one comment. I sent a lot of letters in the last session of Congress about our members.

Mr. GEKAS. Without objection, the written statement will be received for the record.

[The prepared statement of Mr. Hoffman follows:]

PREPARED STATEMENT OF WILLIAM C. HOFFMAN, PRESIDENT, RETIREES TO ELIMINATE STATE INCOME SOURCE TAX (RESIST)

THE BEST KEPT SECRET IN AMERICA

The RESIST of America members and the members of the Coalition, (shown in Attachment A); urge the House to pass H.R. 394. The Library of Congress concluded that Congress has the constitutional right to prohibit states from imposing a tax on nonresident pensions. They reported their results in a Senate Finance Committee hearing, June 11, 1991.

ISSUE

"Taxation Without Representation" still exists in America. The taxation of nonresident pensions by the states is a prime example. This tax affects every American without regard to gender, race, religion, or even income level. It is a totally bipartisan issue. Our Senior population faces many problems and uncertainties as they grow older; including failing health and shrinking financial resources. The ignoble practice by the states of taxing retirees on nonresident pensions adds to these burdens. Most retirees were totally unaware that their former state(s) would tax them for the rest of their lives without giving any benefits or rights. Even worse, states like California, mailed letters to retirees in the 1970's; telling them they did not owe

this tax. Then they have the nerve to send these people a tax bill that includes 5 percent in penalties plus daily interest. What would you do if you or your parents were suddenly faced with a huge tax bill that equaled or exceeded yearly income? A few of these tragic cases are included later.

My wife, Joanne, has worked with me from the beginning. She handles most of our phone calls and letters. After eight years of this activity, tears still flow when she reads or hears another of these tragic stories. She asked me to invite you to spend time with her and listen to these stories. I wish we could confirm the suspected heart attacks that occurred as a result of these tax shocks.

How can a nation that was formed over the issue of "Taxation Without Representation" allow this to happen? *Because it was the best kept secret in America!* No one was told about this unfair tax that interferes with our right to travel across our country and live where we choose *without suffering a financial penalty.* It is *unthinkable* for an individual in the United States of America to be controlled by a taxing agency without recourse. More important, how can our great Nation allow Senior Citizens to be treated in this terrible manner.

BACKGROUND

Many states (41) have source tax laws and each of them could implement the tax on nonresident pensions. About 12 states currently impose this tax. I will frequently use California as an example during this presentation for three reasons:

1. They are the most aggressive state,
2. They often lead the Nation in new trends, and
3. We have a better understanding of their nonresident laws and procedures.

The 41 states mentioned above, tax nonresidents on various types of source income. There are legitimate reasons for some of these taxes. An individual could operate a business, own property or work in a nonresident state. In these cases, the resources of the state are being used or jobs are taken from the residents. If the nonresident doesn't want to pay these taxes, they can remove the business or property from the state or not work there. They have a choice.

Nonresident taxation of pensions is different; because unlike a business, job, or investment, the pension tax debt cannot be removed from the state. The retiree is trapped for the rest of their lives by the state in "financial slavery."

States can raise taxes whenever they like. What can nonresidents do about it? *Nothing!* We can't vote or petition in our former state.

One of our members tried to register in California as a nonresident voter. After the usual bureaucratic exchange, his request for registration was, of course, denied, even though he is expected to pay California taxes. This persistent member has proven that at least California will not allow a nonresident to register and vote.

What services do we get as nonresident taxpayers? *None!* We can't use schools, or even buy a fishing license at resident rates. Of course, you can use the schools and buy a fishing license at nonresident rates, which are much higher.

What do we get from the government of the taxing state? *Nothing!* Except harassment from collection agencies.

THIS TAX HITS RETIREES HARD!

I am including only five letters of the thousands we have received about real people affected by this unfair tax. An example: involving a family who was told they didn't have to pay the non-resident tax and then had their pension garnished; involving "double taxation through intimidation"; of true double taxation; that shows how states even go after retirees with low incomes; and an example of just how uncontrolled and unsympathetic tax agencies can be.

Example One: Howard Smith retired from the Los Angeles Police Department in 1974. In 1988, Howard and his wife Nancy were contacted by the California Franchise Tax Board (CFTB). They told him that he had not been paying taxes on his pension. His accountant (now deceased) was told by the California FTB, years earlier, that he did not have to pay these taxes. Jim Reber, spokesman for this agency, stated in a Sacramento Bee Article, May 20, 1989, that they sent letters to nonresident retirees throughout the 1970's telling them they did not have to pay taxes on their pension. He then said; "It was a mistake."

When the California FTB is challenged, they search through the years for more unpaid taxes on the individual. In Howard's case, they went back to 1983. His tax liability continued to grow. Washington is one of the states that passed a law prohibiting the seizure of assets for the collection of these taxes. The FTB was undaunted, however. In March 1993, Howard's pension check did not arrive. He subsequently received a notice from the California FTB, through his pension office, stating that his check had been seized. Furthermore, they would withhold 25 percent

of his subsequent checks until his debt was paid, unless he settled in 30 days. At this point, his tax liability was $26,394.59. Howard Smith's pension is about $27,000 per year.

We believe that pensions are exempt from garnishments. Federal law protects, the military, ERISA (Private), and Federal pensions from garnishments, except for child or spousal support. We thought California's own law under Enforcement of Judgments, Title 9, Art. 704.110 exempted state pensions from garnishments, except for child or spousal support. The California FTB admitted they could not garnish most pensions, but Howard's police pension was an exception. Whether they are correct or not, the only recourse for the retiree is to sue the state. This costs money and causes anguish.

Howard's case has been published in the Wall Street Journal, Thursday, April 15, 1993, by Earl C. Gottschalk Jr., "Welcome Traveler," and on Dan Rather's CBS Evening News, Friday, May 21, 1993. His debt had grown to more than $28,000 when the show was broadcast and is now more than $35,000. Even though his pension has been garnished, he continues to lose ground financially.

Example Two: The states continue to say that retirees are never double taxed. They claim one state or the other always gives credits. This contention is not always true. If a reciprocal agreement does not exist between the states involved, the taxpayer often finds himself caught in a legal quagmire. David Sheehan and his wife, Dawn, for several years paid taxes to South Carolina. California demanded that they pay taxes on essentially the same income for several years. Later, South Carolina changed their law and gave them a credit for taxes paid to California. In the meantime, the Sheehan's incurred a large tax debt (more than $5,000) to California. Later, the Sheehans moved to Maine. Maine does not tax nonresident pensions and therefore does not give rebates for taxes paid to other states on pensions. Because of their earlier experience, the Sheehans were *afraid* to challenge California and are paying taxes to both states on the same income. It is probable that California would give some credit for taxes paid to Maine. But as David told me, they live more than three thousand miles from California, and they cannot afford to travel there or hire an attorney to fight them. *This amounts to double taxation through intimidation!* It is almost impossible for an isolated retiree to fight a powerful lax agency. I'm confident that many other Senior Citizens find themselves in similar dilemmas.

Example Three: There are cases of authentic double taxation as well. Mr. Earl Cornwell worked 33 years for Rockwell International, the first 22 years in Iowa and the last 11 years in Oklahoma. He is now retired in Oklahoma. He is required to pay Iowa on 66 percent of his retirement income. Oklahoma gives only a partial credit. For the years 1991 and 1992 he paid Iowa $2,290. Oklahoma only allowed a credit of $769. He was double taxed on the $1,521 difference. The tax payers of Oklahoma also suffer because they pay for the services, etc., of retirees like Earl and the states that receive the retirees' taxes contribute *nothing* to their support. Iowa repealed their tax on nonresident pensions on Wednesday, May 5, 1994, and thus removed themselves from Bob Brinker's "Hall of Shame." Bob Brinker hosts a weekly radio show "Money Talks." Perhaps Mr. Cornwell's problem is now solved.

Example Four: Gertrude Eberly calls herself the "Bag Lady" of Fallon. She has had national publicity regarding her case. Nevertheless, her saga continues. She owes the State of California more than $13,000. Her yearly income is about $13,000. Because of the publicity, the California FTB agreed to let her pay $50 per month on her tax debt. She made the payments until it became a choice between paying the tax and paying her gas and electric bills. She decided to pay the gas and electric bill. She is now forced to depend on Nevada's law that prohibits seizure of property for nonpayment of these taxes. Unfortunately, she was a state worker and California may now seize her pension check at the source as they did in Howard Smith's case. Gertrude's plight is getting worse as she is now legally blind and is being harassed by collection agencies.

Example Five: We often get letters that are so outrageous that they not only bring tears to Joanne's eyes, but to mine also. We are adding to the hundreds of letters submitted to the last Congress, one from Ellen Wight of Arizona. Her problem illustrates the terrible burden that the nonresident tax imposes on Seniors. Ellen wrote us to thank us for our last newsletter and to donate to our cause. In that letter she told us that her husband, Bert, had terminal colon cancer. Their California taxes for 1994 were $4,799 because Ellen had to withdraw $6,000 from their IRA to help pay the medical bills. Unbelievably, California had also added a tax for earthquakes. We returned her donation and offered her our condolences. She wrote us again and told us Bert had died. One of his last acts was to write Representative Stump of Arizona and urge him to keep up the fight to repeal the tax on nonresident pensions because his fight was over.

Rhetorical Question: If Gertrude or others in her situation go broke because of this tax, which state pays for the required welfare, (the resident or former state)?

TAX ALSO HITS COMPANIES HARD

Another aspect of this tax often forgotten, is the financial impact on companies. Under present law, they are required to keep extensive records of present and former employees that have vested in a pension plan. These records are expensive and difficult to implement. The main reason companies did not support the compromise Bill passed in the 103rd Congress was that it didn't provide relief from this expensive record keeping.

STATES POSITION

Some states correctly assume pensions are intangibles, similar to savings accounts. Others claim pensions are deferred income.

Defining pensions as "deferred income" is totally incorrect. Income that is deferred should be paid unconditionally, either to the retiree or to their heirs. Pensions clearly do not meet this requirement. If you unfortunately die one day before you retire, your heirs receive only your own contributions plus a small amount of interest. Your estate receives none of the so called "deferred income."

Most retirees paid taxes on contributions to their pension plans. Apparently, Companies, Federal, and State agencies did not pay taxes on their contributions to pension plans or investment interest. Before the publicity that RESIST of America initiated, no one was informed, by either their State or employer, about nonresident taxation of retirement income. Why weren't we informed about this unfair tax that would lead to "Taxation Without Representation" in the future? Why weren't options to settle offered to the employees?

My Company, Hughes Aircraft, held a 3 day seminar for future retirees and their wives. Just about every topic regarding retirement was covered, except one. They didn't even give us a hint that California would tax nonresident pensions. Hughes had more than 12,000 nonresident retirees when I retired in 1987.

I do not generally use our personal situation to illustrate a point. However, I am unaware of anyone else that has offered to settle with the State of California, except my wife and me. It is our unshakable belief that it is intolerable to be taxed by a taxing agency over which you have no control. However, we learned our employer did not pay taxes on their contributions, and there was an unpaid tax obligation. Therefore, even though we had *never* been told about this obligation, we made a written offer of settlement in 1990. The only provision to the settlement was that we would be exempt from any more nonresident taxes on our pension. The offer was based on estimates of unpaid taxes by my employer and on the income California would realize by investing our settlement. The income California would derive through the settlement was greater than the taxes they would collect by taxing me and/or my wife each year until we die. We had many conversations with the Legal Council of the California FTB. We even traveled to Sacramento and met with the Chief Counsel, Glen Rigby, and Terry Collins, who is responsible for nonresident taxes. They both agreed that our settlement was fair, but they could not find the means to accept our offer. When you examine all the unconscionable things the FTB has accomplished, you find their preliminary conclusions unbelievable. *If collecting money is not their objective, what is?*

The only reason for deferring taxable income is to pay fewer taxes on the income later. Nonresident retirees might pay significantly more taxes instead of less. It is particularly frightening to speculate on how high nonresident taxes could become in the future. When a State needs more income, and raises taxes, a nonresident can do nothing about it. The retiree cannot vote, petition, receive benefits or enjoy governmental protection from the taxing State. This situation is intolerable.

AMNESTY

I have been concerned by an issue that is not addressed in the current bills. The current bills will stop the taxation of nonresident pensions from the date of passage. They do not provide a solution for retirees that are now faced with a huge nonresident tax bill. Adding an amnesty clause in the current bill would solve this problem. I would encourage Congress to consider this addition. I do not, however, want to jeopardize the passage of the important legislation (H.R. 394). Amnesty, raises problems concerning those retirees that have paid the tax. Do you require the states to refund these taxes or provide some other solution? States previously have offered amnesty for resident tax payers. As far as I know these states didn't worry about the honest residents that faithfully paid their taxes.

Reference: Tax Notes, July 13, 1992, "State Taxation of Nonresident's Pension Income," by Walter Hellerstein and James Charles Smith, both Professors of Law at the University of Georgia.

At first glance, the article written by these professors from the University of Georgia, supports the arguments of our opposition. When the article is read carefully, it becomes clear that there are several points that do support our position. Although the paper doesn't find theoretical grounds for stopping states from imposing taxes on nonresident pensions, they do find practical objections.

I agree with the theoretical analysis with one exception. The authors assume that if residents and nonresidents are taxed equally, then the tax is appropriate. They miss an important point. The former states claim that benefits were received when the retirees were earning the pension. Therefore, they owe taxes for the rest of their lives, and do not deserve any additional benefits.

There is a fallacy to this argument. Consider two similar retirees. One decides to remain in the state where the pension was earned and the other moves to another state. The resident pays taxes, but continues to receive benefits from the state, can vote, petition, and otherwise be represented by the government of that state. The nonresident pays taxes, but receives nothing. Didn't the retiree who remained in the state also get benefits while they were earning their pension? *Isn't this discrimination? How can this be equal treatment?*

One practical objection Hellerstein and Smith raised is that the states are never concerned about the precise amount of taxes owed by the retiree. They conclude that the state must precisely determine how much tax is owed, before the retiree leaves the state.

Quote from referenced article, Page 226, Paragraph 3:

> Because states generally lack the constitutional power to tax the portion of a former resident's pension income that reflects accumulations after the taxpayer's change of residence, states must limit their taxation of nonresident pension income to the deferred employment income and the income accumulated prior to the retiree's change of residence. As a practical matter, it may be difficult, if not impossible, for a state (or for an employer with state withholding tax obligations) to determine, on a pension-check-by-pension-check basis, what proportion of the payment reflects deferred payment for services rendered in the state and what proportion represents investment income that accrued while the taxpayer was a nonresident of the state.

This paper also states that we would have a Pyrrhic victory for nonresidents if our bills pass, because the states would either stop deferring the tax or would collect it when the retiree left the state.

It is my belief, that states will probably not stop deferring the tax. They can't predict which employees would remain in the state. Therefore, if the state stopped the tax deferment, they could not tax *resident* or nonresident pensions. We have suggested from the beginning that states should collect the tax when the retiree leaves the state. It is not only appropriate that states ask for a settlement when a retiree leaves the state, but economical for the state. The only provisions that they should be required to follow are:

1. Use a fair settlement option similar to a 401(K) and;
2. Inform those in the pension plans about their states' nonresident tax policy, when contributions are made to the plan.

This option would yield the states more money, and stop the "financial slavery" caused by taxing nonresident pensions for life. Apparently the authors of this paper believe that a lump sum settlement when you leave the state would be unconstitutional, while a settlement over the entire lifetime of a retiree is constitutional. As an engineer and scientist, trained to think logically, I am baffled by this conclusion.

Throughout the paper there is the implication that "Taxation Without Representation" is a trite phrase, used to emotionally incite the retirees. This implication is without foundation. *Any society that permits a taxing agency to tax people with impunity when the taxed person has no means (legal or other) to prevent or influence the amount of tax is doomed.* Our Founding Fathers did not consider this issue trite.

RESIST OF AMERICA IS FORMED

It was this unfair tax that prompted us to form RESIST of America. We are a nonprofit organization that was incorporated July 28, 1988. Our only goal is to end the tax on nonresident pensions by the states. It is a "grass roots" organization, under U.S.C. 501, (Ch. 4), that operates entirely through unpaid volunteers, unlike

the American Association of Retired Persons (AARP). We are not against fair taxation with representation.

CONSTITUTIONALITY OF NONRESIDENT TAXES

One of the first officials contacted by our organization about this issue was The Attorney General of Nevada. It was our hope that he would challenge the constitutionality of the nonresident tax on pensions by the states. We knew that it was unconstitutional for a citizen to sue a state in a Federal court. Unfortunately, Brian McKay, who was Nevada's Attorney General in 1988, told us that the U.S. Supreme court had upheld the nonresident taxes about 70 years ago. He sent us the Michigan State Law review, that discussed many cases covering this general issue. He recommended that we try to get Federal Legislation passed. Research into other court cases and investigation of The California State Law Review confirmed his position.

CALIFORNIA HAS IT BOTH WAYS

California has obtained (from their point of view) delightfully contradictory court rulings. One such contradiction is described in the following paragraphs:

BORCHER-BAUSTIAN

The *Borcher* case, which was overlooked by the Library of Congress, was tried in district court 2 of Los Angeles, California. It involved a man who earned his pension in Illinois; and moved to California to retire. Borcher claimed that he didn't owe California taxes on his pension income because the *Source* of his pension was Illinois. California disagreed. Borcher lost, after a ten-year court battle. The court decided he must pay taxes on his pension to California.

The *Baustian* case involved a man who earned his pension in California and retired to Idaho. California claimed that he owed nonresident taxes on his pension because the *Source* of his pension was California. This decision was made by the State Board of Equalization. The cases occurred about the same time.

As a spokesperson for the California FTB cheerfully acknowledged, in Barron's National Business and Financial Weekly, September 11, 1989, by Michael Brody:

> No-Escape Clause,
> Residents can be taxed on all income, regardless of its source; nonresidents are taxed on all source income regardless of residence.

To make matters worse, California hired collection agencies that use "Gestapo Tactics" to harass and threaten Senior Citizens for the collection of these *unfair* taxes. We have been criticized by Hellerstein and Smith for using the phrase "Gestapo Tactics" to describe California's uncivilized procedures. This phrase was used, because it applies. We have been unable to find a more suitable phrase. They also offer rewards for information on delinquent taxpayers. Other states will probably follow California's lead, as they have for the nonresident Professional Athlete tax discussed later.

INCOME EARNED IN OTHER STATES ALSO TAXED

There is another point that has irritated Seniors Citizens. Several states use total income earned (including income earned in other states) to establish the highest rate for taxing pensions (the California Method). The income from other states includes property sold, wife's income (even a new wife that never lived in the taxing state), investments, etc. Even so, these states claim they do not tax out of state income. However, any increase in taxes as a result of including income not earned in the former state, is clearly a tax against that income.

This procedure creates inequality between retirees. A retiree, that supplements their income through investments, can decrease their tax liability by investing in items (such as Federal Securities) that states cannot tax. Those retirees that must work to supplement their pension have no opt inns and must include the additional income. As a result, they pay more taxes than the retiree that invests, even if their total income is the same.

CALIFORNIA, PERHAPS OTHER STATES, TAX NONRESIDENT, MILITARY PENSIONS

Some believe that California does not tax the nonresident pensions of military personnel. Don't you believe it. Check California tax forms 1005 and 1032. California previously gave an exemption for military personnel (the maximum exemption was a generous $40.00 per year). Effective January 1993, they repealed the exemption. Other states have not answered the question of whether they tax military pensions. We suspect most do.

CAN WE SOLVE THIS PROBLEM AT THE STATE LEVEL?

There are some Congressmen and organizations (AARP for example) that believe that we should work through the states and organizations like the Multi-State Tax Commission to end this tax on nonresident pensions. We have tried. It is almost impossible to sway State Legislators when you are not represented. New Jersey and Iowa are the only states that have been persuaded to stop taxing nonresident pensions. This success occurred in New Jersey's case, because of the efforts of one the National Association of Retired Federal Employees (NARFE) member; and due to a study by New Jersey that demonstrated the collection of these taxes was not economical. Iowa investigated all aspects of the tax and concluded that the income from the tax did not compensate for the negative factors Iowa faced from imposing this unpopular tax.

Our efforts with California have been futile to say the least. In *1990,* the California Legislature introduced two bills to prevent or limit the taxation of nonresident pensions. AB–3976, that would have completely ended this unfair tax and AB–3963, that would have given a $20,000 credit to nonresidents, but income earned in other states would still be used to determine the tax rate. AB–3963 also contained a "sunset clause" that automatically repealed the law 6 years after enactment.

Trice Harvey, an Assemblyman from Bakersfield, invited me, Pierce Powers (National Association of Retired Federal Employees—NARFE), Elton Hipport also from NARFE, and Douglas Baldwin, representing the Air Force Association, to testify before the Revenue and Taxation Committee for AB–3976.

Johan Klehs, Chairman of this committee (District San Leandro) refused to let us testify, claiming there was not enough time and that we were "out of order." The testimony for and against the previous issue, to grant tax exempt status for businesses that grow ostriches for food involved less than a dozen people. They listened to testimony for more than two hours (not counting two hours for the ostrich barbecue).

Our issue involved millions of Senior Citizens and Future Senior Citizens in the State. Clearly, we were faced with a "stacked deck." The committee has every right to oppose our position; however, there is never a reason to be rude and inconsiderate to anyone. Johan Klehs treated us like people without representation.

I had subsequently written a letter to the former Speaker of the California Assembly, Willie Brown, and suggested a plan that would end their unfair tax method and yield California more income. We have had no success with him.

The following year AB–1513, SB–427, and AJR–25 were introduced. The two bills would have repealed the tax on nonresident pensions, and the joint resolution urged the United States Congress to pass the bills that prohibit this tax. This time it was Dick Millington (former Regional Vice President—NARFE) who received the rude treatment.

In 1994, the California FTB sponsored state legislation AB–300 to give a $30,000 deduction to nonresident pensions. It included a two year "sunset clause." While this legislation would reduce taxes for retirees, it doesn't solve the basic problem. Retirees would still be under the control of the California FTB. Furthermore, about a dozen other states are still taxing nonresident pensions. One wonders if the California FTB isn't trying to diffuse the momentum of our effort and *"pull the wool over the eyes of Congress."* AB–300 failed to get through Johan Klehs' Committee.

"STOP GAP" LEGISLATION PASSED BY MANY STATES

Nine states have passed legislation to prevent the seizure of property for the collection of taxes on pensions or retirement income (Arizona, Colorado, Florida, Louisiana, Nevada, New Hampshire, New Mexico, Texas, and Washington). A number of other states are considering similar legislation. An economic war between the states has begun.

Where can we turn for help? We can only turn to you, the Congress of the United States. When state borders are crossed, individual rights must be protected by the Federal Government.

WE NEED FEDERAL LEGISLATION! THE CONGRESS OF THE UNITED STATES IS OUR LAST HOPE!

We are asking you, The Congress to help us end this terrible injustice to our Seniors and our Future Seniors. The issue of taxation of nonresident pensions by the states affects every American. Even if a citizen does not have a pension or if they never leave the state where the pension is earned, they are affected.

Many states give credits or rebates to retirees that pay taxes to another state. If they do, then the taxpayers of that state are paying for the benefits, services, and

cost of government for these retirees. The taxes paid by the retirees, are instead paid to their former state, that doesn't give anything to the retirees or the resident state's economy. Even if the resident state does not give credits or rebates for these taxes, their citizens still lose, because the money paid by the retirees for taxes is not available for expenditure in the resident state.

There is a better way. Taxpayers should pay taxes only to their state of residence, where they receive benefits, services and government protection, where they have the right to vote, petition, and otherwise influence their representatives.

The states, that tax nonresident pensions, consider those without income tax as "nontaxing" states. While this is obviously not true, retirees in these states are truly *double taxed*. Because the former state does not recognize any of these taxes as offsets against their tax, these retirees pay taxes to both states and therefore are *double taxed*.

Four bills have been introduced into the House of Representatives to stop states from taxing nonresident pensions, (H.R. 394, H.R. 371, H.R. 744, and H.R. 1762). Representative Barbara Vucanovich, Nevada, introduced H.R. 394 into the House Judiciary Committee. Senator Harry Reid, Nevada, introduced an identical Senate Bill S. 44 into the Senate Finance Committee. These bills would end the injustice to Senior Citizens, including members of Congress. Representative Bob Stump, Arizona, introduced Bill, H.R. 371, into the Judiciary Committee, Wednesday, January 4, 1995. This bill is similar to the bill originally introduced by Representative Vucanovich. Representative Stump was a cosponsor on the first bill in 1988. He has supported our legislation from the beginning and only introduced H.R. 371 to get early attention in the House, not to compete with the other bills. Representative Owen Pickett, Virginia, introduced Bill H.R. 744 Monday, January 30, 1995. His bill is similar to the Bill H.R. 702 introduced in the 103rd Congress by Representative Vucanovich. Representative John Ensign, Nevada, introduced Bill H.R. 1762 Wednesday, June 7, 1995, into the Ways and Means Committee. This bill accomplishes most of the objectives of Bill H.R. 394. It conforms to the rules of the Ways and Means Committee and imposes a penalty on the states if they tax nonresident pensions.

DO THESE BILLS COST THE FEDERAL GOVERNMENT?

Unlike most people requesting legislation, we are not asking for money, only *justice*. The Federal Government should realize a slight increase in tax revenue if H.R. 394 passes, because those retirees that still itemize on their Federal taxes would have fewer deductions.

States would not lose income either if our bills pass. Ironically, if we do not pass H.R. 394 and the Senate Bill S. 44, the most aggressive state, California would lose. They are one of the two top retirement States (Florida is the other). When states that currently don't impose the tax, realize that California or other states in Brinker's "Hall of Shame" are stealing money from their economy, you can bet they will retaliate and impose nonresident taxes on their retirees. The retaliation has already started in the case of nonresident professional athletes.

California taxes these athletes for every game they play in the state. At least Colorado, Maryland, Massachusetts, Louisiana, Michigan, Minnesota, Missouri, Oregon, Pennsylvania, Illinois, New Jersey, New York, Ohio, Wisconsin, and a city (Philadelphia) have retaliated. The Illinois Legislature called their tax "Jordan's revenge." See The Wall Street Journal Article, Thursday, April 15, 1993, by Earl C. Gottschalk Jr., "Welcome Traveler." See also, Money, Southwest Airlines (Spirit) by Jim Henderson, "Tax Down." It is difficult to predict which state would lose the most, but one situation is easy to predict. If taxes are paid to the State of Residence, where the retiree can vote, petition, receive services and benefits, everyone gains, including the states.

We urge you to pass H.R. 394 and end the tyranny of "Taxation Without Representation," without a financial loss to the Federal Government and without a loss to the states.

Stop this terrible injustice to our Senior Citizens and to all Americans.

Mr. GEKAS. We now turn to Mr. Farrell.

STATEMENT OF W. CHRISTOPHER FARRELL, LEGISLATIVE REPRESENTATIVE, NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES (NARFE)

Mr. FARRELL. Chairman Gekas and members of the committee, for the record, I am Chris Farrell, legislative representative for the

National Association of Retired Federal Employees. On behalf of the half-million members of NARFE, I would like to express our appreciation for this opportunity to testify on the State taxation of nonresident pension income.

NARFE's interest in this subject stems from three biennial national conventions that have adopted resolutions seeking enactment of Federal legislation to allow retirees to relocate without being financially indentured to a jurisdiction of previous residence.

Our California members, the vast majority of whom have no intention of leaving, oppose the source-taxing practice of their own State government and seek enactment of legislation to allow them to relocate to any other State if they so choose without continued tax obligations to California.

NARFE strongly supports the legislation pending before the subcommittee that would prohibit the current practice of several States, namely the taxation of disbursements of pension funds—pension plans of former residents. Specifically, NARFE supports H.R. 394 sponsored by Representative Vucanovich.

In 1991, NARFE submitted testimony in support of similar legislation to the hearing record of the Senate Subcommittee on Taxation. In 1993, we testified at an oversight hearing of your predecessor subcommittee on two 103d Congress bills previously mentioned by their sponsors. The developments in this legislation owe much to the efforts of Nevada's Senator Harry Reid, the Joint Tax Committee, and consideration in the Finance Committee during 1991 and 1992.

Taxation deferred should not be converted into tax avoidance. Rather, States defer taxation during the peak wage earning years so that citizens will continue to be contributing taxpayers rather than needy paupers when retired.

Sometimes this issue is seen only as an issue for public sector retirees. While State and municipal retirees are the most exposed to pension source tax because their paymaster is able to withhold before disbursement, as is occurring in the documented case that appeared on the "CBS Evening News," private sector employers consider source tax compliance extremely difficult, if not impossible. The American Payroll Association and the Tax Executive Institute have considerable expertise in this area to provide to the subcommittee.

Rather than seeing the present practice of a small number of States as a clear and present danger to Western civilization as we know it, left unaddressed by a higher legislature, the Congress, rational State legislative behavior will lead to an increasing number of States initiating an aggressive source tax in retaliation, if nothing else, for the egregious behavior of the California Franchise Tax Board. Why should any State with the authority allow its departing citizens to leave unencumbered when citizens, late of California, are umbilical to Sacramento?

Several State legislatures, at least eight, we believe, perhaps nine, have enacted legislation to prevent their State courts from being party to the enforcement of liens for debts claimed to be owed to other States based on pension source tax. This too is rational State legislative behavior but detrimental to the basic philosophy of voluntary compliance.

Left unaddressed by Congress, as the legislature of last resort, this issue will become more and more salient. You may have newly arrived constituents who are not now aroused, but will be if their former State of residence seeks to tax them using the source tax. Should this occur, they must turn to you as they can no longer participate in any meaningful way in the civic life of the State they have left behind.

In its opportunistic application, the source tax has created a litany of horror stories well recounted by RESIST. While these case histories are happening primarily in a few Western States now, the experience will necessarily spread.

Increased labor mobility, one of the great engines of the American economy, provides ripe targets. Faster computers combing through larger data bases provide the means, and the States' appetite for revenue to supply essential and mandated services provide ample motive. This problem will not go a way. Just the opposite is true. Rational State legislators believe the old tax theory: Don't tax thee, don't tax me, tax the man behind the tree, who just happens to be over the State line.

Some trade unions and progressive tax theorists believe State source taxes are a device for the income-tax States to punish non-income-tax States. This contention is worthy of closer examination, and I will be ready to answer any questions that you might have about my testimony in the question period.

Thank you.

[The prepared statement of Mr. Farrell follows:]

PREPARED STATEMENT OF CHRISTOPHER FARRELL, LEGISLATIVE REPRESENTATIVE, NATIONAL ASSOCIATION OF RETIRED FEDERAL EMPLOYEES (NARFE)

Chairman Gekas and Members of the Committee, for the record, I am Chris Farrell, Legislative Representative of the National Association of Retired Federal Employees (NARFE). On behalf of the half million members of NARFE, I would like to express our appreciation for this opportunity to testify on State Taxation of Nonresidents' Pension Income.

NARFE's interest in this subject stems from the three biennial national conventions (1990, 1992 and 1994) that have adopted resolutions seeking enactment of federal legislation to allow retirees to relocate without being financially indentured to a jurisdiction of previous residence. Our California members, the vast majority of whom have no intention of leaving, oppose the source-taxing practices of their own state government and seek enactment of legislation to allow them to relocate to another state, if they so choose, without continued tax obligations to California.

NARFE strongly supports the legislation pending before the Subcommittee that would prohibit the current practice of several states, namely the taxation of the disbursements of pension plans of former residents. Specifically, NARFE supports H.R. 394 sponsored by Representative Vucanovich.

In 1991, NARFE submitted testimony in support of similar legislation to the hearing record of the Senate Subcommittee on Taxation. In 1993, we testified at an oversight hearing by your predecessor subcommittee on two 103rd Congress bills, H.R. 702 and H.R. 546. These measures were a limitation rather than outright prohibition of state authority to source tax.

The developments in this legislation owe much to the efforts of Nevada's Senator Harry Reid, the Joint Tax Committee, and the consideration in the Finance Committee during 1991 and 1992.

Taxation deferred should not be converted into tax avoidance. Rather, states defer taxation during the peak wage earning years so that citizens will continue to be contributing taxpayers rather than needy paupers when retired.

Sometimes this issue is seen as only an issue for public sector retirees. While state and municipal retirees are the most exposed to pension source tax because their paymaster is able to withhold before disbursement, as is occurring in the case documented in Ray Brady's report on the CBS Evening News, private sector employers consider source tax compliance extremely difficult. The American Payroll Asso-

ciation and Tax Executives Institute have considerable expertise in this area to provide to the Subcommittee.

Rather than seeing the present practice of a small number of states as a clear and present danger to western civilization as we know it, left unaddressed by a higher legislature, the Congress, rational state legislative behavior will lead to an increasing number of states initiating an aggressive source tax in retaliation, if nothing else, for the egregious behavior of the California Franchise Tax Board. Why should any state with the authority (only New Jersey and Iowa among the states with a broad based income tax are specifically prohibited from source taxing) allow its departing citizens to leave unencumbered when citizens, late of California, are umbilicated to Sacramento. Several state legislatures (Arizona, Colorado, Florida, Louisiana, Nevada, New Mexico, Texas and Washington) have enacted legislation to prevent their state courts from being a party to the enforcement of liens for debts claimed to be owed to other states based on pension source tax. This too is rational state solon behavior but detrimental to the basic philosophy of voluntary compliance.

Left unaddressed by Congress, as the legislature of last resort, this issue will become more and more salient. You may have newly arrived constituents who are not aroused now, but will be if their former state of residence seeks to tax them using the source tax. Should this occur they must turn to you as they can no longer participate in a meaningful way in the civic life of their former state(s). In addition to paying taxes to a jurisdiction where they no longer consume state services, the new state of residence where they currently do consume resources must do without the economic benefit the source taxed individual would otherwise provide it in various taxes and greater consumer spending.

In its opportunistic application, the source tax has created a litany of horror stories well recounted in the RESIST of America testimony in June of 1991 and July 1993 and quite likely today. While these case histories are happening primarily in a few western states now, the experience will spread. Increased labor mobility, one of the great engines of the American economy, provides ripe targets, faster computers combing larger databases provide the means, and the states' appetites for revenue to supply essential and mandated services provides ample motive. This problem will not go away. Just the opposite is true. Rational state legislators believe the old tax theory, "don't tax thee, don't tax me, tax the man behind the tree" who just happens to be over the state line.

Some trade unions and progressive tax theorists believe state source taxes are a device for the income tax states to punish the non-income tax states. This contention is worthy of closer examination. The California-Nevada and New York-Florida retirement trails are well worn but they are not the only paths, and there is no one reason why people migrate in retirement.

Before state tax administrations require the exchange of computer tapes with every other jurisdiction, this Committee could look over the horizon and save rational actors from the logical consequences of their actions. Efficient administration of state government is consistent with the collection of taxes on the income of current resident citizens but inefficient and inherently discriminatory when aimed at some, easily found, former residents now domiciled in other states. On behalf of our members in every state and district, NARFE urges you and the Subcommittee to favorably report H.R. 394.

Again, I thank you, Mr. Chairman, for the chance to present the convention established views of NARFE members.

STATE SOURCE TAX FACT SHEET

States Which Are Known to Tax Nonresidents on Federal Annuities Earned There

California: State law explicitly imposes taxes on the retirement income of nonresidents who earned the right to receive such income within California's boundaries.

Idaho: State law includes a provision under which nonresidents are subject to tax for "[a]ny...income which is not specifically exempt under the IRS code..."

Oregon: The state taxes nonresidents retirement income to the extent the right to receive it was earned as a result of personal services performed within its boundaries.

States Which Do Not Tax Nonresidents on Federal Annuities Earned There

Colorado: The state generally does tax nonresidents on income they earn within its border, although nonresidents' pension income is excluded from taxable income.

Connecticut: Income distributed from a qualified pension or retirement plan to nonresidents is exempt from state taxation; Note: a nonqualified pension or retirement plan is not exempt.

Delaware: "If the taxpayer is now not a resident of Delaware and receives a pension from the Federal government...the pension is not taxable..." *Delaware Tax Newsgram*

Hawaii: State law allows exclusions from taxable income for any "public" retirement system and "[a]ny compensation received in the form of a pension for past services.

Iowa: SF 2074 was passed during the 1994 legislative session and signed by Governor Branstad. As a result of the enactment of this bill, Iowa becomes only the second state (New Jersey being the other) to relinquish its right to collect source tax. Iowa was previously an aggressive source taxing

Nebraska: "Nonresidents who are receiving pensions, deferred compensation, or annuities based on service performed within Nebraska in an earlier tax year do not have income from Nebraska sources."

New Jersey: The income of a nonresident individual shall not include income derived from sources within NJ from pensions and annuities as set forth in New Jersey state code 54A.5-1

Special Cases

Kansas: Income earned within the state's boundaries by nonresidents generally is subject to tax. However, no statutory provision or annotation explicitly states that Kansas taxes the retirement income of nonresidents.

All Other States

The overwhelming majority of the states have not announced explicit rules with respect to whether or not they consider retirement income of nonresidents to be subject to their income taxes. Most of these states do, however, have provisions of law which generally regard retirement income as includible in gross income subject to tax and which generally subject nonresidents to their income taxes if the nonresidents earn income as the result of the performance of personal services within their boundaries. These states are

Arizona	Minnesota	Oklahoma
Arkansas	Missouri	Rhode Isle.
Georgia	New Mexico	S. Carolina
Indiana	North Carolina	Utah
Maine	North Dakota	Vermont
Maryland	Ohio	Virginia
		W. Virginia

States That Protect Residents' Personal Property From Liens Placed by Source Taxing States

Arizona	Louisiana	Texas
Colorado	Nevada	Washington
Florida	New Mexico	

Information was provided in part by the Congressional Research Service Report for Congress "State Taxation of Nonresidents' Retirement Income", Robert Burdette, December 21, 1992

Mr. GEKAS. I thank the gentleman and turn to Mr. Duncan.

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Thank you very much, Mr. Chairman.

My name is Harley Duncan, and I am executive director of the Federation of Tax Administrators. The federation is an association of the principal tax administration agencies in each of the 50 States, the District of Columbia, and New York City. I would like to make five points this morning.

First, this is not a question of the legal authority of the States to tax the pension income of former residents. It is well established that States may tax such income. The income in question here was earned within the State, and the tax on it was simply deferred. Moving out of State should not automatically convert this deferral into an exemption. States must maintain their ability to tax income earned within their borders if they are to retain their sovereignty within our Federal system and serve the needs of their citizens.

Second, the amount of misinformation on State practices in this area is extreme and it serves, in my estimation, to cloud the debate. A review of State practices that was undertaken at the request of this committee last year, and which we are in the process of updating even as we speak, indicates that there are approximately 15 States whose statutes permit them to tax some portion of the deferred income of a former resident. There are four important facts in this area.

First and most important, there is only one State, the State of California, that has an active program of enforcing—the tax obligation on annuity payments of former residents.

The second important fact is that, of the remainder, probably 10 to 12 of those generally tax, if not exclusively tax, only distributions from nonqualified deferred compensation programs.

Instructive in this regard is the State of Pennsylvania which, as you know, Mr. Chairman, has a broad exemption for retirement income of its residents and its nonresidents. There are court cases in Pennsylvania indicating that certain types of nonqualified deferred comp plans don't count as retirement income in Pennsylvania and they would assert the right to tax a nonqualified distribution to a nonresident.

The third important point: No State, to my knowledge, imposes a reporting obligation on a plan sponsor that falls outside of the requirements of the Internal Revenue Code.

It is further my belief that the Employee Retirement and Security Act, ERISA would probably clearly preempt those sorts of reporting obligations.

The fourth important fact: The direction is in States moving away from taxation of nonresident pension income instead of into that area. As Mr. Hoffman pointed out, Iowa recently repealed its law. New Jersey a couple of years ago repealed its law, in large part because of exactly the practical difficulties that you have pointed out and that Professor Smith indicated.

The third point in my testimony is that State tax administrators, I believe, have worked in good faith with the sponsors of this legis-

lation to arrive at a compromise that addresses the problems that are inherent here and, second, preserves State sovereignty.

We tried to establish four principles here: First, to try to preserve to the maximum extent possible the source tax principle; second is not to create opportunities for substantial tax avoidance; third is to design legislation that meets the problems at hand and not a series of hypotheticals; and the fourth is that the law be capable of being administered.

The law that the House of Representatives passed last year, H.R. 546, which would have exempted the first $30,000 in withdrawals from any type of qualified plan, met these criteria, and we did not oppose that. We are willing to accept that bill this year. We would encourage you to go back to that.

We retain our commitment to bills like H.R. 546 that were introduced and considered last year. The State of California has testimony indicating likewise.

The fourth point to make is that the federation does oppose H.R. 394 as it has been introduced this year, principally because of the inclusion of nonqualified deferred compensation plans within the preemptive purview of the bill.

The addition of nonqualified plans creates the opportunity for substantial tax avoidance by highly compensated individuals. These plans are often not considered retirement plans and are generally available only to executives and highly compensated employees. If States are preempted from taxing distributions from such plans, these individuals will be able to structure their earnings in a fashion which would allow them to avoid substantial amounts of State tax by simply deferring income and moving to a non-income-tax State.

Moreover, the inclusion of the nonqualified plans is not necessary to address the problem at hand which, as recently as 2 weeks ago on the "CBS Morning News," was described as helping fixed-income seniors and normal Americans who don't know about their obligations.

Finally, I would point out to you that the Unfunded Mandates Act of 1995 does come into play, would come into play were it in effect. This is an unfunded mandate, and Congress ought to encourage people to work it out with the State legislatures.

Thank you.

[The prepared statement of Mr. Duncan follows:]

PREPARED STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. Chairman and members of the Committee, thank you for inviting me to present the Federation of Tax Administrators' position on proposals to preempt state taxation of nonresident pensions.

The Federation of Tax Administrators (PTA) is a nonprofit corporation comprised of the principal tax and revenue collecting agencies in each of the fifty states, the District of Columbia, and New York City. The Federation is governed by a 15 member Board of Trustees elected by the 52 member agencies. The policy of the Federation with respect to this issue was embodied in Resolution Sixteen adopted unanimously by the membership at its June 1994 Annual Meeting in Cleveland, Ohio.

INTRODUCTION

To begin, let me commend the Committee for asserting jurisdiction on this issue and holding this hearing. Frequently, Congress has limited state taxing authority

without consulting the affected states. Because state taxation is a highly specialized subject, these preemptions have created problems for state governments without necessarily implementing Congressional intent. The expertise to understand the complexities of these issues exists within the House Judiciary Committee, and we always appreciate receiving a proper hearing.

As a general matter, the Federation urges the Congress to move cautiously in considering legislation to restrict the ability of states to tax retirement income paid to former residents. Any such legislation should: (1) preserve to the maximum extent possible the source taxation principle undergirding state income tax systems; (2) not create opportunities for substantial tax avoidance; (3) be designed carefully to address the issues present in today's environment and not a series of hypothetical situations which someone might conjure; and (4) be capable of being administered by being precisely drawn and based upon references to current laws or understood concepts where possible.

As such, the Federation would encourage the Subcommittee, if it feels legislation is necessary and warranted, to return to H.R. 546 as was approved by the Judiciary Committee and House of Representatives last year. That measure meets the criteria outlined above. It intrusiveness into state affairs was minimized. It did not create opportunities for tax avoidance and was addressed to real burdens associated with the manner in which states today tax retirement income of former residents. It also defined the protected income with reference to the Internal Revenue Code so that the sources of protected income are clear and the measure was capable of being administered.

On the other hand, the Federation cannot accept certain of the bills which have been introduced on this subject this year. In particular, H.R. 394 removes the ceiling on protected income and adds "non qualified deferred compensation" arrangements to the list of plans from which the states are preempted. These unwarranted expansions effectively prohibit all taxation of nonresident retirement income by the states, and they open the avenue to substantial tax avoidance by highly compensated individuals.

Source Tax Principle

There should be no question regarding the legal authority of states to tax the pension income of nonresidents.[1] The basis of current state income tax systems is that a state may tax income that is derived from "sources" within the state, regardless of whether it is earned by a resident of the state or a nonresident engaging in income-producing activities within the state. In-state sources are defined generally to in dude the performance of services in the state, the conduct of a trade, business or occupation in the state, or the receipt of income from property owned within the state.

State authority to tax nonresident income from in-state sources was validated by the U.S. Supreme Court over 70 years ago in *Shatter* v. *Carter* 252 U.S. 37 (1920) when it wrote:

> . . . we deem it clear, upon principle as well as authority, that just as a State may impose general income taxes upon its own citizens and residents . . . , it may, as a necessary consequence, levy a duty of like character, and not more onerous in its effect, upon incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein. . . .

As the *Shaffer* court noted, and as has been developed in subsequent cases, the essential constraint on the states in the taxation of nonresident income is that the nonresident not be taxed to a greater degree than a similarly situated resident of the state and may not be discriminated against by virtue of the nonresident status.[2]

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[1] Throughout the testimony, references to nonresident pension or retirement income should be read to refer to that portion of any deferred compensation arrangement which is attributable to services performed in the state at an earlier point in time. A state would not have authority to tax pension income of a nonresident If it did not arise from services or other activities performed in the state.

[2] With respect to nonresident pension income in particular, states take the position that the pension income is simply deferred income or compensation for services performed at an earlier point in time. This issue has not been addressed directly by the Supreme Court. The Court's ruling in *Davis* v. *Michigan Department of Treasury* 109 S.Ct. 1500 (1989) (intergovernmental tax immunity and 4 U.S.C. 111 prevent a state from taxing federal pensions to a greater degree than they do state and local pensions), however, certainly supports the state interpretation that pensions are deferred income paid for services performed previously.

It is also clear that states have authority to tax all income received by a resident, regardless of the source of that income.[3] To avoid double taxation, however, all states with a broad-based income tax[4] provide a tax credit to residents for income taxes paid to another state on income which is also included in the tax base of the state of residence.[5] This system of reciprocal credits generally prevents retirement (and other) income from being taxed in both the state in which it is earned and in the state of residence.[6]

Thus, the authority of states to tax retirement income of former residents is clear. This is income that was earned within a state, and the tax on that income was deferred. Simply moving out of state should not automatically convert this deferral into an outright exemption. States must be able to maintain their ability to tax income earned within their borders if they are to preserve their sovereignty within our federal system and to handle their responsibilities—responsibilities, I might add, that Congress is rapidly increasing.

Current State Practices

The amount of misinformation on state practices in this area is absolutely appalling, and it seems eminently clear that this misinformation, intentionally or unintentionally, is being used to tout the debate and to obfuscate the issues. There is no widespread state taxation of nonresident retirement income, and there is no groundswell of activity that should lead one to believe that if Congress does not act immediately that a large number of states will enter this area. State taxation of nonresident retirement income is limited to a relatively small group of states. Most importantly, these states in most cases limit their taxation to a discrete category of deferred income not commonly defined as retirement plans. Finally, states are not moving to enter into this area of taxation. Instead, the movement is actually in the opposite direction with states moving away from taxing any nonresident retirement income.[7]

The important facts regarding the state income taxation of nonresident income are as follows:[8]

There are 13 states[9] whose statutes permit them to tax some portion of deferred income from a nonresident. Nine of those states generally, if not exclusively, tax income from nonqualified deferred compensation arrangements, not plans recognized as qualified pension arrangements under the Internal Revenue Code;

Only one state—California—has any program in place to enforce tax compliance by nonresidents on annuity payments from qualified retirement plans;

No state imposes an extraordinary reporting obligation on any retirement system administrator or plan sponsor, as it relates to a taxpayer not domiciled in that state, beyond those required under the Internal Revenue Code. Further, it seems likely that the Employee Retirement and Income Security Act of 1976 (ERISA) would preempt states from imposing such requirements.[10]

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[3] *New York ex. rel. Cohn* v. *Graves*, 300 U.S. 308 (1937) and *Lawrence* v. *State Tax Commission*< 286 U.S. 276 (1932).

[4] Forty-one states and the District of Columbia levy a broad-based personal income tax. New Hampshire and Tennessee levy an income tax on limited types of interest, dividend and capital gains income. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not levy a personal income tax.

[5] Maine and Virginia do not grant such a credit on retirement income. Neither state, however, includes retirement income from non-state sources in the tax base of the resident.

[6] Certain groups of states do not use such a system of credits. Instead, they have reciprocal agreements under which all income is taxed by the state of residence rather than the state in which it is earned. (This also avoids taxation by two states.) These agreements are most prevalent in the Virginia-D.C.-Maryland, Pennsylvania-New Jersey, and Ohio-Indiana-Illinois areas.

[7] New Jersey and Iowa have within the last several years enacted legislation to cease the taxation of nonresident retirement income. Similarly, Connecticut in establishing its income tax directed a policy of not taxing nonresident retirement income.

[8] This information was gathered in 1994 at the request of the House Committee on the Judiciary. It was obtained by the Federation of Tax Administrators through phone calls with administrators in each state. States selected for phone calls were those that had been identified at least once as taxing nonresident retirement income in one of several published sources. Survey results have been made available to the Committee and are available from the Federation upon request.

[9] California, Kansas, Louisiana, Oregon, New York, Colorado, Delaware, Michigan, Wisconsin, Connecticut, Massachusetts, Minnesota and Vermont .

[10] In *Fort Halifax Packing Company Inc.* v. Coyne, 482 U.S. 1 (1987), the US. Supreme Court said ERISA preempts states from enacting statutes relating to benefits plans that squire an employer to develop and implement an ongoing administrative program in order to comply with its obligation under the statute. Requiring an employer to withhold state income taxes or report

Continued

PRIOR LEGISLATIVE EFFORTS

State tax administrators—including those from California—have worked hard and in good faith with the sponsors of these bills and with representatives of interested groups to find a compromise that addressed the problem and was precisely structured to not leave state governments wide open to abuse. Those compromises and agreements were embodied in bills before the Senate and the House of Representatives last year. We remain committed to those agreements and do not oppose measures that are similar to or based on those bills.

In this area, the Federation has worked from four principles:

1. Any federal legislation should preserve to the maximum extent possible the source taxation principle undergirding state income tax systems. State tax sovereignty and the ability to provide services to the citizenry require that states have the ability to tax income earned within their borders.
2. Any federal legislation should not create opportunities for substantial tax avoidance by not creating an incentive to enter into arrangements which allow large amounts of income to be recategorized as protected retirement income.
3. Any federal legislation should be designed carefully to address the issues present in today's environment and not a series of hypothetical situations which someone might conjure up.
4. Any federal legislation should be drafted in a manner which is as dear and understandable as possible. In particular, it should define the types of income being protected by references to current federal law or otherwise understood concepts where possible.

Based on these principles, the Federation would encourage the Subcommittee to return to the measure (H.R. 546) as approved by the Judiciary Committee and the House of Representatives last year if it feels federal legislation is warranted. That measure provided that states could not tax the first $30,000 in annual withdrawals from a list of qualified pension plans under the Internal Revenue Code.

H.R. 546 preserved the principle of source taxation and preempted it only in limited circumstances. It did not create opportunities for tax avoidance because the protection was limited in amount and confined to a specified list of commonly known and used retirement arrangements. H.R. 546 was addressed to real burdens associated with the manner in which states today tax the retirement income of former residents in that it would be removed the prospect that the vast majority of Americans would ever have to confront the "source tax" issue. Finally, it defined the protected income with reference to the Internal Revenue Code so that the sources of protected income are clear and the measure was capable of being administered.

CURRENT PROPOSALS

The Federation of Tax Administrators opposes enactment of *H.R. 394* as introduced in the 104th Congress. This measure includes two significant changes from H.R. 546 approved last year:

It has removed the $30,000 limit on the amounts to be exempted annually from state tax; and

It has added to the list of protected income all distributions from nonqualified deferred compensation arrangements.

The Federation opposes H.R. 394 on the following grounds.

Tax Avoidance. By adding nonqualified deferred compensation arrangements to the list of protected income, the bill creates the potential for substantial tax avoidance by relatively small groups of highly compensated individuals. Nonqualified deferred compensation plans are essentially any arrangement negotiated between an employer and employee to delay payment for services rendered. They can range from a simple agreement to pay cash at a later point in time to more complex arrangements imposing conditions on the amounts paid and providing for exotic forms of payment instead of cash. By their nature, they are generally confined to small groups of directors, officers, executives and other highly compensated individuals. They are not the province of the normal working American.

By including nonqualified deferred compensation plans within the preemption, H.R. 394 would expose the states to opportunities for substantial tax avoidance by those able to avail themselves of such arrangements. Highly compensated individuals would be able to enter into arrangements to defer substantial amounts of income in the latter part of their career, receive their distributions immediately upon

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distributions and other information for nonresident retirees would necessitate an or going administrative scheme on the part of the employer to meet its statutory obligation. Such a law would be clearly preempted under Fort Halifax. (Of course, an employer may always withhold on a voluntary basis, if the taxpayer chooses to provide the necessary information.)

establishing residence in a non-income tax state, and thus avoid all state tax on the income.

Not Retirement Income. Nonqualified deferred compensation plans are not generally considered retirement plans per se, but are principally another means of structuring compensation for services which allows the employer to defer payment of the compensation (in return for deferring any tax deduction) and the employee to defer tax on the income (in return for deferring realization of the income.) They are not retirement arrangements of the kind we normally consider such as witnessed by:[11]

There are no requirements for universal coverage of all employees or even universal coverage of employees within a given class;

There are no pre-funding or trust arrangements required as with qualified plans;

There is no minimum age for receiving distributions from such arrangements; and

There are no limits on amounts which may be contributed to such arrangements.

Beyond intended purpose and demonstrated need. Inclusion of distributions from nonqualified deferred compensation plans not only creates the potential for tax avoidance, but it is not necessary to meet the intent of the sponsors as we understand it. Over the years this issue has been discussed, the focus has always been on minimizing the compliance burden on persons with pension earnings that relate to a lifetime of work. As Rep. Vucanovich said on CBS two weeks ago, the need is to help ordinary people who are on fixed incomes and may not even be aware of the tax burden or be able to deal with potential complexities. Removing the $30,000 limitation and including nonqualified deferred compensation plans within the purview of the bill are certainly not necessary to achieve this purpose.

Moreover, there has been no showing that nonqualified deferred compensation arrangements should be included in the preemption of the bill. There has been no indication of complexities faced by taxpayers. Instead, it appears to be an attempt to avoid paying lawfully owed state taxes.

H.R. 371 by Rep. Stump would preempt state taxation of all pension income earned by nonresidents. The Federation opposes this measure because of its breadth. It is not targeted to the problem which has been presented. Further, there are no definitions of what constitutes pension income which will undoubtedly lead to lengthy and costly litigation to establish the parameters of the bill.

H.R. 744 by Rep. Pickett is similar to measures considered by this Committee in other years. It would prohibit the states from taxing annuity income from certain qualified plans and allow taxpayers a one-time exclusion for lump sum withdrawals of up to $25,000 from those plans. The concept of this bill is acceptable to state tax administrators in that the preemption is limited and the focus is on the problem identified. I would suggest, however, that the concept of differentiating between lump sum and annuity payments should be examined and whether the one-time exclusion presents some unnecessary complexity. (See also Statement of Gerald Goldberg, Executive Officer, California Franchise Tax Board.)

Unfunded Mandates

The second piece of legislation passed by the 104th Congress was S. 1, the Unfunded Mandates Act of 1995, which declares that Congress shall resist placing additional mandates on state governments without funding them and without studying the revenue costs of such mandates. Here is an opportunity to show good faith to that principle. H.R. 394 and the other measures constitute a mandate on state governments. They require that states refrain from taxing in a manner which is otherwise available to them. As such, they impose constraints on the generation of revenues to meet the policy priorities as the state might establish them.

Moreover, that legislation when effective will require that the Congressional Budget Office estimate the cost of such mandates (including revenues states are prevented from collecting) when they exceed $50 million annually. California estimates that pending legislation will reduce its revenues by at least $25 million per year. H.R. 394 should be properly viewed from its perspective as an unfunded mandate, and all interested parties should be encouraged to pursue the recourse available to them in state legislatures. (See also Statement of Gerald H. Goldberg, Executive Officer, California Franchise Tax Board, on this point.)

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[11] In point of fact, the section of law (IRC § 3121(v)(2)(C)) referencing nonqualified deferred compensation plans is designed for the purpose of subjecting contributions to such plans to employment taxes as contrasted to a list of qualified plans, the contributions to which are exempt.

CONCLUSION

I conclude my remarks with this detail: For the record, if legislation is passed, Congress should clarify in the Committee Report that state law definitions of residency are to be respected. There exists no federal counterpart definition and substantial case law has developed around state definitions of residency for state tax purposes.

Thank you for the opportunity to appear. I will be happy to answer any questions. We are also willing to work with the Subcommittee and its staff as these proposals are considered.

Mr. GEKAS. I thank the gentleman, and we turn to Mr. Johnson.

STATEMENT OF RANDALL L. JOHNSON, DIRECTOR OF BENEFITS PLANNING, MOTOROLA

Mr. JOHNSON. Good morning, Mr. Chairman.

My name is Randy Johnson. I am director of benefits planning at Motorola in Schaumburg, IL. I appear before you today on behalf of the American Council of Life Insurance, the Association of Private Pension and Welfare Plans, the Committee on State Taxation, the ERISA Industry Committee, and the Profit Sharing Council of America. These organizations are working together through the Retirement Savings Network, a broad-based group of associations representing employers and service providers concerned about employer-provided retirement plans.

I am accompanied by John Vine of Covington & Burling, legal counsel to the ERISA Industry Committee.

I would like to begin today by telling you a little bit about Motorola.

Mr. GEKAS. Can you spell Mr. Vine's name?

Mr. JOHNSON. V-I-N-E.

Mr. GEKAS. I should have guessed. All right. Thank you.

Mr. JOHNSON. I would like to begin today by telling you a little bit about Motorola. I think this will help you understand why we are so concerned about the State source taxes.

Motorola has 76,000 employees in the United States. We do business in 50 States and around the world and commonly transfer employees from State to State and country to country. It is not unusual for a Motorola employee to work in from 5 to 10 States during the course of his or her career.

We maintain two qualified retirement plans, a defined benefit plan, commonly called a pension plan, and a defined contribution plan, commonly called a profit-sharing or 401(k) plan. All 76,000 of our employees are salaried and are hourly, are eligible to participate in both of these plans, and we administer both of them at Motorola.

Our defined contribution plan accepts rollovers of payments employees have received from plans of their prior employers, and an employee's average account balance in the defined contribution plan is about $41,000. It is not uncommon for nonmanagement, nonsupervisory employees, to have an account balance of as much as $300,000 at the end of his or her career with our company.

In addition to our company contribution, this has resulted from our encouraging employees to invest for the future and relatively favorable investment returns, which is very important in a time when all of us are concerned about the national savings rate.

Nearly all the benefits paid under the defined contribution plans are paid as lump sum distributions. At many companies, lump sums are also paid from defined benefit plans. Motorola, like many other companies, also has a nonqualified plan for employees with compensation or benefits that exceed the limits that tax laws impose on qualified defined benefit plans.

These plans are not—I emphasize not—just for upper-level executives. For example, sales people with unusually high earnings in a given year can be covered by this plan. Technical and lower to middle-level managers can also be found in these kinds of plans.

In this setting, State source taxes create insoluble recordkeeping allocation and apportionment problems, not just for Motorola but for thousands and thousands of retirees, employers, and plant administrators who face similar problems.

It would be virtually impossible for a nonresident retiree to contest a tax assessment made by a distant State. First, the employee will be unfamiliar with the State tax laws and unable to obtain any records that might support his or her position. There is no reason for the employee to have maintained such records.

Second, employers and plan administrators do not have the records necessary to allocate retirement payments among States or to allocate each payment between compensation for services and investment earnings. Employers and plan administrators have never maintained records that reflect the benefit each participant has earned in each State.

Like Motorola, an increasing number of plans now accept rollovers from other plans. In order to account for such distributions, for the source of distributions, a plan accepting rollovers would have to account not only for the benefits earned under that plan but also for the benefits earned under the plans of prior employers. Plans simply do not have the records that would permit them to do this.

H.R. 394 addresses these problems by prohibiting any State from imposing an income tax on the retirement income of an individual who is not a resident or domiciliary of that State. We support this approach. We oppose the narrower approach in H.R. 744. This bill would provide only relief for certain qualified plans and, even then, only for certain annuity and installment options and only for up to $25,000 in benefits paid in any other form in a single year. These restrictions prevent the bill from solving the problems created by source taxes. In our judgment, the enactment of H.R. 744 would be a worse solution than the enactment of no bill at all.

I thank you, Mr. Chairman, for the opportunity to testify and would be pleased to respond to your question.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF RANDALL L. JOHNSON, DIRECTOR OF BENEFITS PLANNING, MOTOROLA

Mr. Chairman and members of the Subcommittee. My name is Randy Johnson. I am Director of Benefits Planning at Motorola. Motorola is headquartered in Schaumburg, Illinois, and produces high technology electronics products.

I appear before you this morning on behalf of the American Council of Life Insurance, the Association of Private Pension and Welfare Plans, the Committee On State Taxation, the ERISA Industry Committee, and the Profit Sharing Council of America, all of whom participated in the development of this Statement. These organizations are working together through the Retirement Savings Network, a broad-based

group of associations representing employer and service providers concerned about employer-provided retirement plans.

I am accompanied by John M. Vine of Convington & Burling, counsel to the ERISA Industry Committee.

SUMMARY OF POSITION

The groups I represent strongly support enactment of H.R. 394. This bill properly addresses the enormous practical problems arising from the treatment of nonresidents' retirement income under State source tax laws.

Under State source tax laws, a retiree can be taxed on his retirement income by each of the States in which he worked during his career, even though he does not reside in, vote in, or benefit from public services in any of those States. As a result, retirees can be taxed on the same income by multiple jurisdictions, and retirees, employers, and plan administrators face insoluble recordkeeping, allocation, and apportionment problems. Unless States are prohibited from taxing nonresidents on their retirement income, increasing numbers of retirees will be overtaxed, and more and more retirees, employers, and plan administrators may be forced to endure an endless and mind-boggling tax-accounting nightmare. A nonresident retiree is in a weak position from which to contest a tax assessment made by a distant State, especially when he is unfamiliar with the State's tax laws and unable to obtain any records that might support his position.

At present, only a small minority of States (less than a dozen) attempt to tax the retirement income of nonresidents. Some States do not tax nonresidents at all; others have the legal authority to do so, but do not attempt to tax their retirement income as a practical matter. The judgment of the great majority of States is that it is either inappropriate or impractical for a State to track down former residents to tax their retirement income.

The fact that only a small number of States are involved makes it all the more important that Congress act promptly before efforts to tax nonresidents' retirement income spread. We are concerned that States whose residents are now being taxed by other States might react to these efforts by attempting to collect their own income taxes from residents of other States.

H.R. 394 addresses these problems by prohibiting any State from imposing an income tax on the retirement income of an individual who is not a resident or domiciliary of that State. We support this approach.

H.R. 371 prohibits a State from imposing an income tax on the pension income of any individual who is not a resident or domiciliary of that State. Although we support the objectives of H.R. 371, we are concerned about the bill's failure to define the critical term "pension income." The absence of a definition causes the bill's meaning and effect to be uncertain.

By contrast, H.R. 394 defines "retirement income," the operative term used in that bill. We strongly prefer the approach taken by H.R. 394.

We oppose the narrower approach taken in H.R. 744, which would provide relief only for certain qualified plans, and even then, only for benefits paid in certain annuity or installment forms and only for up to $25,000 in benefits paid in any other form in a single year. These restrictions prevent the bill from solving the problems created by State source taxes. In our judgment, enactment of H.R. 744 would be worse than enactment of no bill at all.

STATE SOURCE TAXES OVERBURDEN AND OVERTAX NONRESIDENT RETIREES

If a State wishes to tax a nonresident on his retirement income, it may tax only the portion of the retirement income that the retiree earned in that State. This is known as "source taxation" because it seeks to tax income derived from sources within the State. Source taxes require the retiree's retirement income to be allocated among all of the States in which he worked. A State may not tax a nonresident retiree on retirement payments earned outside its jurisdiction.

In addition, although the courts are not all in agreement, a number of them have treated the earnings on amounts deferred under a retirement plan as investment earnings rather than as compensation for services.[1] A State may not tax investment earnings realized by a nonresident. As a result, it also is necessary for a retiree to allocate his retirement payments between compensation for services and investment earnings.

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[1] *See, e.g., Molter* v. *Dep't of Treasury,* 443 Mich. 537, 505 N.W.2d 244 (1993); *Pardee* v. *State Tax Comm'n,* 89 A.D.2d 294, 456 N.Y.S.2d 459 (N.Y. App. Div. 1982).

Retirees do not have the records needed to make these allocations. Retirees simply have no reason to preserve compensation, employment, and retirement plan investment earnings records over periods of 30 or 40 years or longer. And retirees are not able to obtain these records from their former employers, because employers do not have these records either.

More fundamentally, there is no generally agreed upon way of allocating retirement income among States. Certainly the States have not agreed on a uniform methodology. The States do not even have a uniform definition of a "resident" of a State; they have differing approaches to determining when income is attributable to sources within the State; and they differ on the extent to which deferred compensation is considered to consist of investment earnings as opposed to compensation for services.

Assume, for example, that an employee retires after 35 years of service with the same employer under a pension plan that provides a benefit equal to 1% of the employee's final average earnings multiplied by his years of service, up to a maximum of 30 years. If the employee worked in seven States during his career, each for a period of five years, there is no generally agreed-upon method for allocating his retirement income among the seven States. It is uncertain whether the portion of the retirement income allocable to the last State in which he worked is worth zero because he had previously reached the 30-year limit on service, or whether the portion of the retirement income allocable to that State should be increased to reflect a large pay increase that the retiree received during his last five years of service.

In addition, the retiree has no way to identify the portion of the plan's investment earnings allocable to his retirement income. Under a defined benefit pension plan, there is simply no way to make an allocation of this kind; it generally is not meaningful to allocate a distribution from a defined benefit plan between compensation and investment earnings. Although it is theoretically possible to identify the portion of a distribution from a defined contribution plan (such as a profit-sharing, 401(k), or savings plan) that is allocable to the plan's investment earnings, a retiree does not, as a practical matter, have (or have access to) the records needed to make such an allocation.

The retiree will not receive any help from the State tax agencies. They do not have the records either. A State agency typically taxes the entire amount of a retirement distribution and puts the burden on the retiree to prove that he is not taxable by that State on the full amount of the distribution.

Even apart from the lack of records and the absence of an agreed-upon methodology, a retiree who has earned retirement benefits in more than one source-tax State must file an income tax return in each State for each year in which he receives retirement income. Given the mobility of our Nation's workforce, this is no small matter. It is not unusual for an employee to have worked in as many as five or six states during his career, even while working for a single company. It is unreasonable and unrealistic to expect a retiree to be able to familiarize himself with the tax laws and tax filing requirements of five or six States with which he no longer has any connection. In addition, a nonresident retiree is in a weak position from which to contest a tax assessment made by a distant State, especially when he is unfamiliar with that State's tax laws and unable to obtain any records that might support his position.

Moreover, State source taxes subject many retirees to multiple taxation on the same retirement income. Although States that impose income taxes provide credits for residents who earn income in other States, tax credits do not work properly, even in theory, unless the source tax States agree on the amount of retirement income to be allocated to each State and the individual properly calculates and claims them. The problem is that the States do not always agree on the allocation of retirement income among States. And even where they do agree, this puts the burden on the retiree to properly allocate his retirement income among the relevant States and to calculate and claim the correct amount of the tax credit.

Many retirees are unaware of the availability of tax credits; others do not know how to take advantage of tax credits or lack the records to do so; and in still other cases, the statute of limitations prevents the retiree from taking advantage of tax credits. A retiree often needs professional assistance in order to take advantage of the available tax credits, and this only adds to the costs borne by the retiree.

And where a portion of the retiree's retirement income represents investment earnings, as opposed to compensation for services, the potential for overtaxation by source tax States is compounded, since there are no records that permit a retiree who has worked in more than one State to identify the contributions and investment earnings allocable to each State.

Retirees are justifiably enraged by State source taxes. Before their retirement, few retirees are aware of the potential for multiple taxation. Multiple bills for back

taxes—often accompanied by demands for interest and penalties—frustrate their retirement planning and severely threaten many retirees who are attempting to live on fixed incomes.

Retirees justifiably view the imposition of a State source tax as fundamentally unfair. The tax is often imposed by a State with which the retiree has had little or no contact for many years. The retiree does not live there, vote there, or use the State's public services.

Because a nonresident retiree has no vote, and because few active workers are even aware of the source tax, State legislatures have little or no incentive to respond to nonresident retirees' needs. Under the circumstances, it is hardly surprising that many nonresidents believe that State source taxes subject them to taxation without representation.

Although a nonresident retiree might once have benefited from the State's public services, he was fully subject to the State's tax system at that time. Now that the retiree resides in another State, he is responsible for paying taxes to that State, and it is understandable that he is angry and upset when he receives demands from other States for back taxes, interest, and penalties.

Employers and Plan Administrators Cannot Possibly Meet the Demands That State Source Taxes Make on Them

Employers and plan administrators simply do not have the records necessary to allocate retirement payments among States or to allocate each payment between compensation for services and investment earnings. Employers and plan administrators have never maintained, and have never had any reason to maintain, records that reflect the States in which each plan participant has worked, the period in which each participant worked in each State, the compensation each participant earned in each State, or the benefit each participant accrued in each State.

In the case of a defined benefit pension plan, this would require separate calculation of each participant's benefit in each State in which he worked. In the case of a defined contribution plan, such as a profit-sharing, 401(k), or savings plan, this would require the creation of a separate account for each State in which the participant worked in order to reflect employer contributions, employee contributions, and investment earnings on a State-by-State basis. The burden of maintaining such records would be monumental.

Similarly, employers and plan administrators have had no reason to keep records that permit them to allocate retirement income payments between compensation for services and investment earnings. As I have explained, in the case of a defined benefit pension plan, it is not clear how a meaningful allocation could be made. In the case of a defined contribution plan, a State-by-State allocation between compensation and investment earnings would require the plan administrator to create a separate bookkeeping account for each State in which each participant worked, and to establish separate subaccounts to reflect employer contributions, employee contributions, and investment earnings accrued in that State. The proliferation of accounts would be extraordinary; it would impose enormous administrative and financial burdens on employers and plan administrators. I am not aware of any plan in the United States that maintains such accounts, and I do not believe that there is one.

In response to the Unemployment Compensation Amendments of 1992, an increasing number of plans now accept rollovers from other plans. In order to account for the source of distributions, a plan accepting rollovers would have to account not only for the benefits accrued under that plan but also for benefits accrued under the plans of participants' prior employers. Plans simply do not have the records that would permit them to do this. Plans do not, and cannot reasonably be asked to, account for benefits accrued under the plans of prior employers.

The Internal Revenue Service's new simplified tax and wage reporting system ("STAWRS") will not solve any of these problems. STAWRS will combine State and federal information returns, and will give States access to the Federal Government's data bank on wage and income information, but it will not solve the recordkeeping and allocation problems that apply to nonresidents' retirement income. Although STAWRS might increase a State's ability to track down its retired former residents, and thereby magnify the problems I have described, STAWRS will provide no information that will assist a retiree in avoiding excess State taxation.

State Source Taxes Undermine the Voluntary Employee Benefit System

Applying State source taxes to the retirement income of nonresident retirees would undermine the voluntary employee benefit system and defeat the objectives Congress sought to achieve when it enacted the Employee Retirement Income Security Act of 1974 ("ERISA").

If plans were to maintain the records required to produce the information retirees need to calculate their State source taxes, the plans' recordkeeping costs would skyrocket. Because a plan administrator cannot know in advance who will be liable for source taxes, the plan would have to maintain records for all participants. As a practical matter, the additional costs would be passed on to plan participants in the form of reduced retirement benefits. All participants in all States would bear these costs, even though only a relatively small number of States and a minority of participants were directly involved.

The recordkeeping costs are likely to be so substantial that many employers will choose to terminate existing plans, or refrain from adopting new plans, rather than spend money that will be invested largely in recordkeeping. Many employers will rationally decide that their limited resources should be spent on current compensation rather than on retirement benefits that are diluted by recordkeeping expenses.

All of this will undermine the Congressional policy favoring the establishment of voluntary employee benefit plans. Congress sought to avoid such situations when it included a broad preemption provision in ERISA. Congress recognized that employers, which are not required by ERISA to adopt employee benefit plans, are far more likely to do so if they can administer a plan efficiently and free from interference from varying State laws. As the Supreme Court observed,

> A patchwork scheme of regulation would introduce considerable inefficiencies in benefit program operation, which might lead those employers with existing plans to reduce benefits, and those without such plans to refrain from adopting them.

Fort Halifax Packing Co. v. *Coyne*, 482 U.S. 1, 11 (1987).

As a result, any State law that sought to require an ERISA-governed plan to maintain records implementing the State's source tax should be preempted by ERISA. But preemption alone does not solve the problem from the plan's standpoint. As long as retirees are potentially subject to State source taxes, retirees will be at risk, and employers and plan administrators will be besieged with requests for information from them regarding the sources of their retirement income.

Retirees should not be put in the position of being overburdened and overtaxed by State source taxes. Employers should not be put in the position of being discouraged from offering retirement plans or put in the position offering retirement plans and then being unable to provide retirees with the information they need to deal effectively with State tax agencies.

THE STATE SOURCE TAX PROBLEM IS NOT ANALOGOUS TO THE EXPATRIATE PROBLEM

At the 1993 Subcommittee hearing on State taxation of nonresidents' pension income, questions were raised as to whether the efforts of the State tax agencies are any different from the efforts of the Federal Government to tax the pension income of a U.S. citizen who has retired to a foreign country.

Although the Federal Government has an interest in taxing the retirement income of U.S. citizens who retire abroad, the Internal Revenue Service's enforcement efforts do not create the same practical problems that arise when States seek to tax nonresidents on their retirement income. Employees retire abroad far less frequently than they retire in other States. And because there is a single Federal Government (as compared to 50 States), the allocation issues that arise at the State level rarely arise when a U.S. citizen moves abroad. The two situations are not comparable.

At the federal level, because all of the retiree's income is typically attributable to services in the United States, there is no allocation problem; all of the retiree's income is allocable to the United States. By contrast, State source taxation requires the retiree's retirement income to be allocated among all of the States in which he worked; a State may not tax a nonresident retiree on retirement payments earned outside its jurisdiction. And as I have explained, there are no records that permit these allocations to be made and no generally agreed-upon methodology for making the allocations.

Similarly, at the federal level, it is unnecessary to allocate each retirement payment between compensation for services and investment earnings; the Internal Revenue Service treats all retirement plan distributions as compensation for services. By contrast, at the State level, such allocations may be necessary because a State is not permitted to tax investment earnings realized by a nonresident. As I explained earlier, where a retiree has worked in more than one State, there are no records that identify the investment earnings attributable to each State in which the retiree worked.

WE SUPPORT H.R. 394

H.R. 394 prohibits any State from imposing an income tax on the retirement income of an individual who is not a resident or domiciliary of that State. The bill broadly defines the operative term "retirement income." The bill is not limited to certain types of qualified plans or to benefits paid in certain forms or to benefits under a specified dollar limit.

We think that H.R. 394 takes the proper approach. We strongly support it.

WHILE WE SUPPORT THE OBJECTIVES OF H.R. 371, WE ARE CONCERNED ABOUT ITS CONSEQUENCES

H.R. 371 prohibits a State from imposing an income tax on the "pension income" of any individual who is not a resident or domiciliary of that State.

Although we support the objectives of H.R. 371, and we commend the bill's sponsors for seeking to address the source tax problem, we are concerned about the bill's failure to define the critical term "pension income." The bill's failure to define this term creates substantial uncertainty about the bill's meaning and effect.

We think it would be a mistake for Congress to attempt to address the State source tax problem by enacting H.R. 371 without clarifying the meaning of the bill. If H.R. 371 is enacted, there doubtless will be a lengthy period during which the bill's meaning will remain uncertain. Litigation probably will be required to resolve many of the questions raised by the bill. A lengthy period of uncertainty and litigation will be contrary to one of the bill's principal objectives: to relieve retirees of uncertainty and worry about their State tax obligations.

By contrast, H.R. 394 defines "retirement income," the comparable term in that bill. We strongly prefer the approach taken by H.R. 394.

WE OPPOSE H.R. 744

H.R. 744 would provide relief only for certain types of qualified plans and, even then, only for benefits paid in certain annuity or installment forms and only for up to $25,000 in benefits paid in any other form in a single year. These restrictions will prevent the bill from solving the problems created by State source taxes. In our judgment, enactment of H.R. 744 would be worse than no bill at all. We oppose H.R. 744.

The narrow focus of the bill could actually harm retirees who receive retirement payments that are not exempt from State source taxes under the bill. By exempting only certain retirement payments, and not others, the bill might invite more States to tax those nonresidents who receive nonexempt retirement payments. The bill would, for the first time that we are aware, provide Congressional support for State taxation of nonresidents' retirement income. Thus, ironically, although H.R. 744 may be a well-intentioned effort to limit State source taxation, it could actually make a bad situation worse by giving official Congressional support to the taxation of nonresidents' retirement income.

The bill's narrow focus would leave unprotected millions of retirees, including retired rank-and-file employees. There is no equitable or principled reason for providing relief for certain types of retirement plans but not for others, for providing relief for certain forms of payment but not for others, or for providing relief for small payments but not for larger payments.

The bill would not protect a retiree who receives a payment from a retirement plan in the form of a lump-sum distribution exceeding $25,000. Rank-and-file employees who work for an employer for a significant period of time are likely to have benefits well in excess of $25,000. The bill also does not appear to protect the retiree who receives a lump-sum distribution of more than $25,000 even if the retiree then rolls the distribution over into an IRA or other tax qualified plan.

Likewise, the bill would not protect a retiree who receives a distribution from a nonqualified plan. Because of the recent reductions in the Internal Revenue Code limits on tax-qualified plans, increasing numbers of rank-and-file employees are now expected to receive retirement income from nonqualified plans.

But the problems go well beyond this. All of the recordkeeping and administrative problems now created by State source taxes will remain under H.R. 744. An employer or plan administrator cannot know in advance whether an employee will elect to receive his retirement income in a lump sum or as an annuity. Nor can an employer or plan administrator identify in advance the employees who will become entitled in the future to benefits exceeding the limits established by H.R. 744. As a result, the recordkeeping and administrative problems that arise today will continue unabated under H.R. 744. H.R. 744 offers no solution; in fact, as I have explained,

it could make matters worse since it might actually encourage more States to tax nonresidents on their retirement income.

This completes my prepared statement. I wish to thank the Chairman and the members of the Subcommittee for the opportunity to testify. I will be pleased to respond to any questions that the Chairman or the members of the Subcommittee might have.

Mr. GEKAS. Yes, thank you very much.

This testimony is very valuable to us, and I state now, as I have stated many times before, this subcommittee has acted on legislation that has come before it as a result of the testimony of the witnesses that had preceded in mind. Many of the final decisions made by this subcommittee on language in a particular bill reflected positions for and against such propositions presented by the various witnesses. So we want you to know that this is well received by us.

The question that I wanted to ask right at the start to Mr. Duncan was his assertion, which seemed to me beneficial, that the States are moving out of this and by themselves are taking the option of not taxing nonresidents. If that be the case, then all that Congress would be doing if we follow through is closing the final door as it were. Don't you see a salutary position here for the Congress in that regard?

Mr. DUNCAN. I think the point that I was trying to make, Mr. Chairman, was that States in particular are moving out of the taxation of the annuity income for—annuity payments to nonresidents—that is, the periodic monthly check, the type of program that California has—because of the difficulty that you have in doing it in an evenhanded fashion.

Those, however, who confine their taxation primarily to the nonqualified area, there has been New Jersey that has moved away from that, but that is a larger group, and I think they feel they can administer that in a fashion which is acceptable to them, and you don't see a lot of movement out of there. The point I was trying to make is, there is not a headlong rush of the States to try to step into this area, tax annuity payments, or if you put a ceiling that said the first $30,000 is exempt, that you would see any large number of States moving in to tax that above $30,000.

Mr. GEKAS. Would you feel better if we left the nonqualified, the unqualified out of this mix and just concentrated on the qualified?

Mr. DUNCAN. I think our folks would feel a lot better about that, Mr. Chairman.

Mr. GEKAS. All right, thank you.

Mr. Johnson, I, too, gather from your testimony that you were considering and describing the Motorola plans, the qualified plans, as what you would want to see not be targets of this type of taxation, source taxation. You leave the question of nonqualified open because Motorola doesn't engage in any nonqualified. Isn't that correct?

Mr. JOHNSON. Well, if I have communicated that, I have miscommunicated, and let me try to start again.

Mr. GEKAS. Yes, I would like that.

Mr. JOHNSON. First, I would like to also address your question to Mr. Duncan. We believe that the recent history in the House and Senate in looking at this subject potentially has given the States an indication of how much of an appetite there is for States to tax,

but if, in fact, this kind of a bill is not passed, that more and more States will in the future tax just to recoup the taxes that they are having taken from their residents and now going to California.

With respect to the nonqualified plans, there is a gross misunderstanding regarding who is in nonqualified plans. We have heard earlier and outside of this room that there is a perception that nonqualified plans cover primarily senior executives. That couldn't be further from the truth. As a matter of fact, these plans—Motorola's, as well as many other companies—cover senior technicians like engineers, they cover middle-level managers, they cover sales people, and others. Secondly, these plans accrue benefits over a significant period of one's career, not just one or two.

So the implication that nonqualified plans are designed to avoid taxes in a significant proportion of cases, if not virtually all, is not consistent with what actual practice is in the companies. Therefore, we believe it is inappropriate to tax the nonqualified plans, just like the qualified plans.

In addition to that, just like for the qualified plans, we don't have the records to determine what the source of the retirement benefit is—that is, what State. The same applies to nonqualified plans, again, because these benefits accrued in these kinds of plans are accrued over a period of time.

Mr. GEKAS. Mr. Hoffman, I don't know if it has been made clear to us by previous statements, but the time of the chairman has expired. I will come back to you in my second round.

The gentleman from Rhode Island.

Mr. REED. Thank you, Mr. Chairman.

Mr. Johnson, how many employees does Motorola have?

Mr. JOHNSON. 76,000.

Mr. REED. And how many would be in qualified pension plans, do you know?

Mr. JOHNSON. 76,000, all of our hourly and salaried employees, and in most companies of significant size qualified plans cover most plans, most employees.

Mr. REED. How many would be in nonqualified plans, Mr. Johnson?

Mr. JOHNSON. Someplace today in our corporation, probably four to five hundred people.

Mr. REED. So you have 76,000 employees who are in qualified plans, and you have 400 in nonqualified plans.

Mr. JOHNSON. Right.

Mr. REED. Thank you.

And either Mr. Duncan or Mr. Johnson, because I think you are both expert in these issues, could you, for my benefit, explain the basic differences between a qualified plan and a nonqualified plan? What are the limits? What pushes you into a nonqualified plan?

Maybe Mr. Duncan can start. You can add, Mr. Johnson.

Mr. DUNCAN. I certainly wouldn't want to be considered an expert in this area, but based on the research I have tried to do for this, it is my understanding that nonqualified plans have certain characteristics to them.

First of all, there are no contribution limits imposed on them under the Internal Revenue Code. Second, there is no requirement for universal coverage of the employee work force or any class of

the work force. The third is that there is not necessarily a time period in which they need to be withdrawn. In other words, there is no 59½ rule or 70½ rule.

I guess those are the three—three or four primary differences between nonqualified plans and what we consider normal retirement income, which has always to this point been the focus of this bill.

Mr. JOHNSON. Increasingly the Internal Revenue Code has placed limits on the amount of benefits a person can accrue, and in most cases these plans are designed to cover those people whose benefits might exceed a limit in a particular year in other years, and it is important to note that many of these plans are part of the ERISA legislation and follow ERISA guidelines.

Mr. REED. Now, Mr. Johnson, you make a point, which is a legitimate one, about, this is not just the two or three chief executives of the company but it is a rather small group of people.

If your company is representative of other companies, and I think there is the possibility, and I am not suggesting Motorola or any company, but the possibility of a—particularly in small companies, in fact, where compensation could be arranged so that there is a conscious and legal effort to avoid State taxes, I think we have to be sensitive to that, and that is one reason where this bright line, at least between qualified and nonqualified, while maybe not satisfying everyone, at least is an attempt at this juncture to deal with that possibility.

Let me ask another question, because an interesting point was brought up in the chairman's questioning of Professor Smith, and that is this notion of, does it make any sense to have a $30,000 exemption, given all the practical problems of tracing income and calculating income, et cetera? And since you represent the tax administrators, Mr. Duncan, why should we support any type of exemption? Shouldn't it be sort of, everything is taxed or nothing is taxed? All qualified or just nonqualified, et cetera?

Mr. DUNCAN. I would make two points in that regard. The first is that the change that this committee made last year to the bill as it was introduced I think was an important one. Previously, the limit was $25,000, once in a lifetime on a lump sum withdrawal, and this committee said it is $30,000 a year regardless of the type of withdrawal. I think that was an important and beneficial change, both for consistency across people and understandability.

The second, as to, should there be a cap of any sort? I guess the perspective that we have taken is that we want to address the real problems that exist out there. Data that I have seen indicated a couple of years ago that a ceiling of $20,000 a year on the payments out of the California public employees retirement system would have covered something well in excess of three-fourths of the retirees at that point, if not more.

So we wanted to address the problems at hand and avoid the potential for arrangements that would lead to tax avoidance, and that is why the idea of a cap was put in the bill.

Mr. REED. Thank you, Mr. Chairman.

Mr. GEKAS. The gentleman from Virginia.

Mr. SCOTT. Thank you, Mr. Chairman.

Maybe I am missing something. I thought the major difference in a qualified plan and nonqualified plan is the nonqualified was after-tax money. Is that not true?

Mr. JOHNSON. That is not true in any case that I can recall, though there might be specific reasons to do that.

I think, Congressman Scott, there is another reason for nonqualified plans, and that is, increasingly, as we become global companies, people will earn some of their retirement income in countries other than the United States, and in order to have those people who are traveling overseas—and, again, this is not merely senior management, this is a trend of our whole management progression—in order for us to provide protection for a loss of retirement benefits, not just for senior executives but any person who is traveling overseas, we will increasingly have and have today nonqualified plans to make up for protection of that kind of money.

I also want to make one other point. Whether it is a $30,000 cap or whether it is a nonqualified plan, the problem exists—and, Congressman Scott, you pointed out earlier today, there are no records that companies can provide to allow a person, much less the company, to calculate that tax.

Mr. SCOTT. Well, as your employees move around to different plants in different States, do you withhold State tax for each of those States where they are actually working?

Mr. JOHNSON. We do withhold taxes for States obviously, but we have not retained those kinds of records down through the years, and a person might be living in one State, working in another, and I think some of those——

Mr. SCOTT. I would be interested in the source State where the money is being made.

Mr. JOHNSON. Where the money is—I'm sorry?

Mr. SCOTT. Is being made. And how long do you keep your records?

Mr. JOHNSON. I have not looked at the exact records but merely long enough to meet the Internal Revenue Code retirements.

Mr. SCOTT. Three to five years? Is that about it?

Mr. JOHNSON. Maybe.

Mr. SCOTT. What has been your experience with California and other States going after some of your employees for source taxes?

Mr. JOHNSON. Our particular experience has not been as great as that described by Mr. Hoffman. Our concern is the——

Mr. SCOTT. Wait a minute. I assume Mr. Hoffman's situation has a lot of State employees where the State has the check and can essentially garnish the check. For a private employer, you haven't seen that much—is that because you don't have plants in California and a couple of other States?

Mr. JOHNSON. A predominant number of other employees are not from California. Only a small segment come from California and some of the other States where there are taxes.

Our concern is the potential increase for the future. If this kind of legislation is not enacted, we think that there will potentially be other States that will increase their aggressive behavior in this area.

Mr. SCOTT. Mr. Hoffman, I assume that most of your members are either State employees or people that have gotten caught up in and hit with deficiencies.

Mr. HOFFMAN. No, that is really not true. I would say our members are equally divided between military, State, Federal, and, private. I have a private pension. I haven't found it on Internet yet. I will. California, I believe, has a law that requires their employees to report this. I have a paper in front of me which——

Mr. SCOTT. Say that again.

Mr. HOFFMAN. They have a law which requires the companies within the State of California to report their nonresident employees by Social Security number, et cetera.

Now, the reason I didn't submit the document that is in front of me is, we got it from a member out of the Franchise Tax Board and the legislator who is studying ways to combat our effort to stop this. It was done in 1992. But an attachment to that particular one says "notice requirements," and one of the requirements says that every employee is required to provide the Franchise Tax Board with the name, Social Security, last known address, and number of years of service the employee performed service for the employer. I believe that is in their law. But if you have ever looked at California's laws, you would find that their table of contents for their tax codes is over 50 pages. So I am having trouble finding it, but I will at some point.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. GEKAS. I thank the gentleman.

One other question I have on my abbreviated second round, and that is, I have never, through all the testimony that I have heard now for several years, determined whether in the California system for collecting the tax is withholding or billing. Which is it?

Mr. HOFFMAN. The system in California is billing. They have passed laws that allow them to use collection agencies, which is probably the worst part of this, because most of the retirees are unaware that they owe any taxes and then all of a sudden they get this enormous bill—I forget the form number—that says you owe these taxes. Usually that amount is incorrect and, interestingly enough, is always higher than what the retiree would really owe.

Mr. GEKAS. So they don't withhold at the source on the pension check.

Mr. HOFFMAN. No, they don't, although in the Ford Rockwell letters that were sent to their employees, they told their employees to please tell them which States they work in, which substantiates Mr. Johnson's point that the companies didn't know, and, if they did not, they were going to send forms to every State that Rockwell or Ford, as the case may be, had business in, and they threatened to withhold taxes for States up to the amount that—you know, comparable proportionate amount that was withheld on Federal.

Now of course you are not required as a retiree to have withholding on Federal. So I guess you could cancel that and they could still send collection agencies after you.

The question that was asked earlier on how many States this affects, our organization has members from every State in the Union; we have members in Saudi Arabia, Mexico, Canada; you can't believe it. Now it is true, most of these cases have to do with Califor-

nia going after people, but not all of them, and I think if you read my written testimony, you will see some of the cases were not between California. The one was between Iowa and Oklahoma, I believe. Now, Iowa has repealed their tax, so that case has probably gone away, but not necessarily because States don't always do this retroactively.

Mr. GEKAS. For our next hearing we will probably invite a sheik of Saudi Arabia to testify on how this legislation might affect them.

We thank the panel. You have been extremely helpful, and——

Mr. JOHNSON. Congressman, could I make one other point?

Mr. GEKAS. Go ahead.

Mr. JOHNSON. Thank you.

I apologize. I responded to Congressman Scott regarding how long we keep earnings and accruals payroll records. It is important to know that pension accruals do not actually track payroll records, and we don't have those pension accrual records year-by-year or any other kind of retirement records year-by-year, whether they be nonqualified plans or qualified plans, and I didn't want to mislead you all with that.

Thank you.

Mr. GEKAS. We thank the panel for their participation, and we will be back to them if necessary. Thank you very much. I would like to submit the following statements for the record: Senator Richard Bryan; Reprensentative Linda Smith; RESIST of America Washington State Chapter; Robert Tobias, National Treasury Employees Union; Gerald H. Goldberg, California Franchise Tax Board; the Military Coalition; American Institute of Certified Public Accountants; C.M. Sgt. James E. Lokovic, Air Force Sergeants Association; J. Randolph Babbitt, Air Line Pilots Association; Matthew P. Fink, Investment Company Institute; Robert T. Scully, National Association of Police Organizations; and Carolyn M. Kelley, American Payroll Association

[The statements follow:]

PREPARED STATEMENT OF HON. RICHARD BRYAN, A SENATOR IN CONGRESS FROM THE STATE OF NEVADA

Thank you, Mr. Chairman and members of the Subcommittee, for this opportunity to provide testimony on the issue of state source taxation of pension income. This outrageous form of taxation without representation has long been a confiscatory thorn in the side of many residents of my state of Nevada.

Over the past decade, Nevada has become the top destination of retirees. There are an estimated 100,000 retirees who have moved to Nevada from the State of California alone. I do not think anyone would deny a retiree their right to move to any state of their choosing. Unfortunately for many retirees, particularly those who have relocated from California, some state tax boards disagree and have embarked upon a policy of relentlessly pursuing retired former residents across the nation. These long-armed tax collectors have located retirees, often many years after they have retired and moved away from the State, and presented them with huge tax bills. For many of these retirees on fixed incomes, they cannot possibly pay the taxes, penalties and fines that are imposed.

Many pensioners move to Nevada with no regard, or awareness, of the tax status of their pensions. It is only when the out-of-state tax collector shows up on their doorstep that they are informed they have a tax obligation to their former state. Considering the longer lives that Americans are enjoying, retirees could well be paying taxes to a state from which they derive no benefit for twenty years or more.

This source taxation of non-resident pension income is unfair on several counts. First, it is clearly taxation without representation, a concept that is antithetical to the very ideals of our democracy. Second, source taxation requires pensioners to pay for services they cannot ever receive. In the case of retirees moving to Nevada from

California, retirees receive all services from the state of Nevada, not California. Yet the state of California believes it has a claim on their pension income. As residents of Nevada, retirees have the right to express their opinions at the ballot box as to how tax dollars are spent. For retirees who must pay taxes to California, they have absolutely no say over spending decisions.

This issue is not just about Nevada and California however. Bill Hoffman, a Nevadan who is testifying at this hearing today, should be commended for taking on this fight in behalf of tens of thousands of retirees who face state source tax burdens. He formed an organization to fight this unfair taxation and today his organization, RESIST, has tens of thousands of members from all fifty states and several foreign countries.

Obviously, the burden of source taxes on pension income falls most heavily on retirees. However, other entities are also burdened as a result of this form of taxation. While retirees living in states that do not impose a state income tax bear the greatest burden of this tax policy, other states also feel an impact. For example, most states allow a tax credit against income taxes paid to other states. This reduces the tax revenue available to the state in which the retiree has residence—even though this state is responsible for providing government services to the retiree. Other taxpayers in the state necessarily bear the burden of replacing this lost revenue.

A burden is also placed on the shoulders of private business. Source taxation is a record-keeping nightmare for companies that run pension plans. If source taxation of pension income becomes the norm, businesses, or the companies administering their pension plans, will be required to construct detailed work histories of individuals showing when a person worked in each state, how much a person earned in that state, and how much of the retirees pension can be attributed to that income. In today's job market, most retirees will have worked for more than one company throughout their careers, adding to the burden.

Nevada and several other states have attempted to eliminate this unfair tax practice. In fact, as Governor of Nevada, I signed into law legislation which prohibits out of state tax collectors from crossing state lines into Nevada to seize the property of Nevada retirees. Unfortunately, providing protection within Nevada's borders is not enough to solve the problem. Federal action is required, indeed it is the only solution.

Legislation Senator Reid and I have introduced in the Senate to eliminate source taxes and similar legislation offered by Congresswoman Vucanovich is essential to provide fairness and to protect the right of thousands of retirees across the nation. Legislation was introduced during the last Congress and passed by both Houses but was held up in the final days of the session. I urge the Subcommittee to pass legislation this session eliminating this form of taxation and resolve this issue once and for all.

Prepared Statement of Hon. Linda Smith, a Representative in Congress From the State of Washington

Mr. Chairman, I commend you for your leadership and willingness to receive testimony on the source tax. Having fought this unfair tax at the state level when I served in the Washington state Legislature, I am quite familiar with the long, hard journey that retirees have traveled to see this tax repealed.

The source tax is truly "taxation without representation." By levying a source tax, states are able to target the retirement income of non-residents even though the non-residents receive no benefits or services in return for the assessed taxes. Thousands of residents throughout my home state of Washington have been burdened by this unfair tax. Many of these retirees once worked in the neighboring states of Oregon or California and found Washington to be a popular place to retire since Washington did not impose a state income tax. Unfortunately, these retirees have seen a good portion of their retirement income go to another state's coffers. These retirees are paying for another state's taxes and do not even get the benefit of the services that their taxes finance.

Congress must put an end to this practice once and for all. I am hopeful that the 104th Congress will send a clear message to America's seniors by eliminating the source tax. I applaud Mrs. Vucanovich for her hard work in furthering this fight and as a cosponsor of her bill, H.R. 394, stand ready to advance this legislation.

PREPARED STATEMENT OF JAMES W. DAWES, WASHINGTON STATE CHAPTER, RESIST OF AMERICA

Chairman Gekas and Members of the Committee, I am submitting testimony favoring the passage of HR–394: "No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State."

1. Constitutionality of the proposed law has been determined, and is in limited operation. (Chapter 4 of Title 4, Section 113—United States Code.)

2. Paying taxes and not receiving benefits from the payments is: "Taxation Without Representation!" As former Representative Craig Washington (TX) has so aptly phrased it: "As citizens, our right to vote and our obligation to pay taxes go hand in hand. To enforce the obligation without extending the right is in no way fair or just."

3. Most pensions were never specified as being tax deferred, and in many cases an income tax was paid, at least on the employee's contribution. It should be unlawful to tax that portion of the retirement income again.

4. A study by the Kiowa Taxpayer's Assc. (Jan. 1992) finds that it is almost impossible to administer a nonresident tax equitably. They state in concluding: "It seems to us that it is one thing to evade a tax which is uniformly proposed and quite another to imposed a tax which by it's own imposition creates evasion." (Iowa has since, passed State law that prohibits their tax agency from pursuing retirees across their borders.)

5. Under the present method used by some States in computing this tax on pension income, they use *total* income (investment earnings, salaries, etc.) which may be sourced outside the taxing State. A retiree in Washington State, who has once resided in California, is required to pay California income tax on Washington lottery winnings. Lottery winnings in California are State tax exempt.

6. When a citizen moves to another State and both States demand income tax payments, a credit is usually given, either by the former State of residency or (in most cases) by the State in which they now live. Only about seven States are without income tax programs, and few others exempt pension income. Why must the migrants to these few States suffer the brunt of this ordeal under the current practice of States taxing nonresidents? Reciprocal tax agreements between States is an expensive procedure with little financial benefit for anyone, and very unnecessarily costly to the filing retiree. This superfluous paperwork should be eliminated.

7. Many income States do not pursue retirees across their borders. Some, probably because of the limited income derived by doing so, or perhaps like Colorado, feel the individual becomes the "award" and responsibility of his new State.

8. These pensioners have sacrificed and saved for many years, and recent economic reversals have reduced their supplemental income, while the cost of living has increased. It's not unusual for a pension to be near or even below the determined poverty level (the greatest percent of Federal Retirees receive, on average, Appx. $1,300 a month).

9. Continued taxing of a nonresident's pension income can only hamper the incentive of workers to make preparation for the years when they can no longer be productive. Destroying this incentive will add to the possibility of Government assistance for them in "old age" (Golden Years).

10. The fact that a sizeable number of nonresident retirees have not yet been approached for this tax, and will when the demand for payment is made, have to pay high interest and exorbitant penalties, provides an atmosphere of anxiety that can readily lead to disruptive nervous disorders for these older citizens. Most of these individuals have always met fair service demands of them. They are not criminals who purposely avoid payment of responsible obligations.

11. Removing "pension income" from being classified as "source income" and abolishing the taxing of the pension by other than the State of residency is a *must,* and the problem will be corrected by passing a bill such as H.R. 394.

PREPARED STATEMENT OF ROBERT M. TOBIAS, NATIONAL PRESIDENT, NATIONAL TREASURY EMPLOYEES UNION

Mr. Chairman, Members of the subcommittee, thank you for scheduling this hearing today to explore the issue of source taxes. On behalf of the more than 150,000 members of the National Treasury Employees Union, I appreciate this opportunity to share our views on the subject of states taxing the pension income of former residents.

A majority of states currently have laws on their books that permit them to reach beyond their borders to collect taxes on pension income received by former residents. Currently, only a handful of states have actually activated their laws and aggres-

sively pursue former residents. In many cases financially strapped states have been driven to collecting source taxes in a desperate attempt to make up for revenue shortfalls within their own borders. Absent federal legislation, curtailing the practice, source taxes are likely to become even more frequently used by states as a source of revenue in the future.

The state of California is by far the most aggressive collector of source taxes. It is my understanding that not only does California go after unsuspecting pensioners for the back taxes, but the state assesses penalties as well as daily interest charges on the balance owed. Furthermore, when computing what it believes to be the amount of taxes owed, the California Franchise Tax Board bases the tax rate on the retiree's total out of state income—not just the pension, or portion of the pension earned in the state. In this way, the retiree's entire annual income is effectively taxed.

Oftentimes, the retiree first becomes aware of his tax obligations to a former state many years after retiring or leaving the state. The bill may arrive carrying years of back taxes, penalties and interest. It is not difficult to imagine how this could come as quite a surprise to the unsuspecting retiree on a fixed and limited income. It is wrong for states to levy such burdens on retirees who happen to be former residents and it is wrong for the federal government to condone the policy. The source taxes that several states now actively pursue are particularly aggravating and unfair to the retiree who may have purposely retired to a state that does not levy a personal income tax in order to preserve a greater portion of his or her limited retirement income.

It is unfair to view the nation's retirees as "cash cows" to bolster state tax revenues, particularly while at the same time, the Congress is once again recommending deep cuts in federal retirement annuities. As you may know, the Fiscal Year 1996 House Budget Resolution seeks to impose an additional 2.5% payroll tax on federal workers. This provision first appeared as part of the tax cut legislation as an offset to provide tax cuts to some of this nation's wealthiest citizens. Federal workers already pay 7% of their salaries toward their retirement. For the average federal employee earning $30,000 annually, this will mean a tax hike of $750.00 per year, the equivalent of a mortgage payment for these middle income earners.

The Budget Resolution would also lower future pension benefits by basing pensions on the highest five years of salary instead of the current highest 3 years. Not only does this Budget ask federal workers to pay more for their annuities—which I might add, 97% of private sector employers pay for entirely without any employee contributions—but it would lower future retirement benefits at the same time by reducing the annuity computation formula.

NTEU staunchly opposes these pension changes just as we have opposed the imposition of source taxes on unsuspecting federal retirees.

With source taxes, the individual has no advance notice of taxes, penalties and interest owed to a former state. The affected retiree no longer has access to state services, no longer uses schools or roads and is no longer given a voice at the ballot box as to how his or her tax dollars are spent. While it is true that the retiree once had access to these state services, the individual paid his or her fair share of taxes to the state while a resident. As a nonresident, all tax liability to the former state should rightly cease.

And, the burden of source taxes is particularly onerous for public sector retirees. States often have more ready access to employment records for public sector retirees and increasingly source taxes are being levied on this group. For those employed by the federal government, it is not uncommon to hold federal positions in several different states during the course of a career. If a federal retiree settles in a state that does not assess a personal income tax, that individual could well find himself receiving tax liability notices from each state where he resided during his working career—each seeking taxes on the portion of the pension earned in that particular state. Americans are a very mobile people, moving from state to state and often job to job. As states continue to face uncertain economic futures, the day may not be far off when a retiree might be required to file numerous state income tax returns to satisfy each state where pension rights were earned. The economic and personal hardships this practice may increasingly levy on unsuspecting retirees must be addressed by Congress. At a minimum, the capacity of states to levy source taxes on those with limited abilities to alter their incomes must be restricted.

I urge this Subcommittee to address the source tax questions and act on the legislation pending before this Congress without delay. Thank you again for this opportunity to share our concerns.

Prepared Statement of Gerald H. Goldberg, Executive Director, California Franchise Tax Board

I am the Executive Officer of the California Franchise Tax Board (FTB) which administers the personal income tax for the State of California. I appreciate your decision to hold hearings on the issue of State source taxation of former residents' pension income and regret I was unable to have someone testify in person at this hearing. I ask that this statement be made a part of the hearing record.

This statement will serve to explain California's rationale for enforcing its source tax laws on former residents who have retired out-of-state. It also describes how pending Federal legislation goes far beyond solving some isolated problems in administering the source tax on former residents' pension income.

I would urge the members of the Subcommittee to carefully scrutinize the policy implications of proposed pension source tax bills for potential conflicts with other significant policy positions adopted by the Congress this session. These positions include the unfunded mandates bill adopted with strong bipartisan support and signed by the President, and proposals to correct tax avoidance by wealthy expatriates. The source tax measures being considered are clearly an unfunded mandate. Further, the source tax principle under attack by these measures is the same principle used to advocate closing tax loopholes exploited by some billionaires.

For the record, the Franchise Tax Board is willing to accept the limits on source taxation as contained in Federal legislation reported out by this Committee last year. State legislative proposals to limit the source tax burden on low income retirees have been supported by the Franchise Tax Board—but unfortunately were not passed. However, the expansive income exemptions included in H.R. 394 are not acceptable and could effectively provide tax free income to high income retirees.

Rationale for Taxing Pension Income of Former Residents

Under existing State and Federal law, an employer's contributions to a qualified retirement plan on behalf of employees are considered compensation and may be deducted as a business expense by the employer. Usually, employer contributions to a qualified retirement plan, as well as any pre-tax employee contributions and any accumulated earnings generated by the plan, are tax-deferred. As such they are not declared as taxable income by the employee until they are distributed.

Under the current State law, California exercises its taxing powers based on two well established and constitutionally approved jurisdictional standards—the residency of the individual and the source of the income. Residents of California are taxed on all income regardless of the geographical source and are provided credits for source taxes paid to another State. Nonresidents are subject to source taxation on income earned in California, such as income earned due to business, property or employment in this State. Business income is taxed using the source principle, and it is the legal basis for States and the U.S. to tax foreign corporations on income earned within our borders.

California also taxes pension and annuity income based on its geographical source. Income, which originally is earned in California, may be deposited for retirement in a nontaxable trust and not taxed until it is distributed by the pension plan administrator. This tax-deferred income remains taxable by California, however, regardless of the recipient's State of residency at the time of its distribution.

To avoid the inequity of double taxation, if the State of residency at the time of distribution also taxes the pension income originally earned in California, a tax credit, roughly equal to the amount of taxes paid to California, is generally available from the State in which the taxpayer resides. California also allows an analogous tax credit. The reciprocal other State's tax credit usually acts to ensure that only one State tax is assessed on the income in question. Consequently, the source tax on pension income mainly affects those retirees who work in California and retire to a State which does not impose an income tax.

Beginning in 1988, electronic data gathering technology was used to identify recipients of pensions from the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) who failed to file income tax returns. The out-of-state pensioners in these systems are, for administrative reasons, effectively the only such group that is subject to California enforcement efforts. This inequity between public and private sector retirees occurs because it is difficult to obtain retirement information when both the payor and the payee are outside the State at the time the retirement income is paid. In addition, ERISA prohibits States from establishing reporting requirements which exceed Federal requirements for the administrators of pension plans. Accordingly, the source tax is relatively easy to collect from non-resident former California public employees, but not from others.

Progressive tax systems are based on the principle that a taxpayer's rate of tax should be determined by the taxpayer's ability to pay. Since 1982, California has required nonresidents to use their total net income from all sources when referring to the tax tables or rate schedules. The resulting tax amount is then apportioned by the ratio California adjusted gross income bears to total adjusted income. This method of determining the rate at which this income is taxed is commonly referred to as the "California method." Roughly 20 States use the "California method" of taxing nonresidents. Existing case law also supports this methodology (*Brady* v. *New York* 607 NE 2d 1060, cert. den. 113 S. Ct. 2998; *U.S.* v. *Kansas,* 810 F2d 935; *Wheeler* v. *Vermont* 249 A. 2d. 887, cert. den. 396 U.S. 949).

Legitimate concerns have been raised that if Federal source tax restrictions are enacted for out-of-state retirees, in-state retirees could be reasonably expected to ask for the same tax relief. If California were to provide tax-free retirement income to all former residents and to in-state retirees, the loss to the California treasury as a result would jump from an estimated $25 million attributable to former residents to a hefty $1.2 billion annually.

Such substantial losses in revenues would inevitably lead California to reconsider its adoption of Federal deferral techniques. If Congress insists on limiting States' rights to tax this income upon receipt, and effectively turns a deferral of taxation into a complete tax exemption, then it could force a major shift in State tax policy regarding pensions. If the implied contract between the State and the pension plan participant is going to be abrogated by the Federal preemption, then eliminating the deferral may be California's only recourse if revenues are to be maintained. Elimination of the deferral would run contrary to the current debate in Washington about devising means to increase the nation's savings rate and helping our citizens to be financially secure for their retirement years.

Pending Federal Legislation

Typically, legislation offered in previous years attempted to confine the remedy to limiting the source tax burden on low income retirees. There are numerous stories of low income retirees receiving a very burdensome tax bill from the FTB on a source tax liability that had accumulated over several years. Last year, the Judiciary Committee reported out a bill that prohibited State source taxation of the first $30,000 in income from qualified pension plan arrangements on an annual basis, be they periodic payments or lump sum distributions. This measure was similar to legislation considered in the California Legislature and supported by the FTB. Although the FTB believes that these matters are best handled by our State Legislature, we would not oppose a Federal bill that provides source tax relief to low income former residents.

However, the new proposal by Rep. Vucanovich is so broad as to provide tax free income to even the wealthiest retirees. H.R. 394 has no cap on the amount that would be exempt from tax so it is not limited to just modest income retirees. Further, the Vucanovich bill adds to the list of pension income certain compensation arrangements that benefit highly compensated employees. Nonqualified deferred compensation arrangements [Section 3121(v)(2)(C)] are often used by highly compensated employees to defer significant income through a nonqualified deferred compensation plan. The employees then take lump sum payments that, under the terms of this bill, could be taxed only by the State of residence, even though all services giving rise to the deferred compensation were performed in another State. This would allow large amounts of compensation to be moved, in the final years of employment, to a lump sum payment. The payment would then be withdrawn immediately upon establishing residency in a State with no income tax.

The bill sponsored by Rep. Stump, H.R. 371, also does not contain a cap on the amount that would be exempt from State tax. The bill does not define pension income, allowing taxpayers and States to interpret the term. The lack of clear definitions would inevitably cause lengthy and costly disputes between taxpayers and the State regarding whether the State is prohibited from taxing pension income.

The bill sponsored by Rep. Pickett, H.R. 744, is similar to legislation approved by this Committee last year. However, this bill excludes the first $25,000 in lump sum payments from the source tax, and completely excludes annuity payments. Applying the $25,000 exclusion only to lump sum payments made from a qualified plan creates an inequity between similarly situated taxpayers. For example, taxpayers who receive annuity payments from a qualified plan will not be required to pay source tax (due to the unlimited exclusion) while taxpayers who receive lump sum payments from a qualified plan would be required to pay source tax on amounts received in excess of $25,000.

The annual revenue loss for California from excluding distributions from qualified pension plans and annuities derived from California source and received by full year nonresidents is estimated to be $25 million at 1995 levels. This estimate does not account for distributions from nonqualified deferred compensation arrangements which are reported on the tax return as wages or salary bonuses.

Unfunded Mandates

The unfunded mandates legislation passed earlier this year contained a provision specifically stating that Federal measures to restrict the revenue raising abilities of State and local governments would be considered an unfunded mandate. If Federal legislation contains limits on revenue raising abilities above the $50 million threshold, then that measure is to be subject to a point of order before consideration by either Chamber. Pending legislation is estimated to cost just the State of California $25 million in lost revenues annually. When the revenue impact on other States that have the authority to collect taxes on former residents is added, the total should easily exceed the $50 million threshold. I would therefore request that the Subcommittee ask the Congressional Budget Office to prepare a revenue estimate of the impact on State and local governments of these measures before moving forward on these bills.

Clearly, Congress has spoken on its intention to prevent further erosion of State and local government revenue bases in the unfunded mandates legislation. The FTB supported that legislation, and although the law does not go into effect until next year, I am confident that members of Congress intend to comply with its spirit. This includes not enacting any measures to restrict the ability of State and local governments to set their own revenue policies. Especially now, when the Federal government is handing over to the States the responsibility for many well established Federal programs, this is not the time or the place to take away our revenue base. If the supporters of Federal legislation would re-direct their energies to State legislative arenas, where this issue belongs, I would gladly work with them to develop State level solutions to this problem.

Expatriates Proposal Applies to Source Taxation of Pension Income

Congress this year debated closing a tax loophole that has allowed wealthy expatriates to renounce their U.S. citizenship in order to avoid paying U.S. taxes. The argument by supporters of closing this loophole is that income and assets earned in this country should be subject to tax by the U.S. Those citizens who renounce their citizenship and no longer reside in the U.S. and take with them their U.S. sourced income and assets cannot avoid their tax obligations. This is precisely the same set of circumstances under which people earn income in one State, move to another State and contend their tax obligation to the State where they earned income no longer applies.

The Senate passed the expatriates measure and the House Ways and Means Committee is considering the matter. Supporting the expatriates measure in order to protect the Federal tax base while opposing the States' right to protect their revenue base on the same principle would be as onerous as the thinking that leads to unfunded mandates.

The hyperbole surrounding source taxation of former residents' pension income has been extreme. I have faith that the Subcommittee will focus on the principles at stake in this issue and act accordingly. I would gladly offer any assistance to the Subcommittee as these proposals are considered.

Prepared Statement of the Military Coalition

The Military Coalition would like to express its appreciation to the Chairman and distinguished members of the House Committee on the Judiciary for the opportunity to present this statement for the record in furtherance of your oversight hearing on the fairness of state taxation of nonresident's pension income in cases where those being taxed used to live and work in the taxing state.

The statement provided herein represents the collective views of the following military and veterans organizations known as the Military Coalition, representing approximately 3.75 million members of the seven uniformed services, officer, enlisted, active, reserve and retired, plus their families and survivors: Air Force Association, Air Force Sergeants Association, Association of Military Surgeons of the United States, Association of the United States Army, Chief Warrant Officer and Warrant Officer Association, United States Coast Guard, Commissioned Officers Association, Enlisted Association of the National Guard of the United States, Fleet Re-

serve Association, Jewish War Veterans of the United States of America, Marine Corps League, Marine Corps Reserve Officers Association, Military Chaplains Association of the United States of America, National Association for Uniformed Services, National Guard Association of the United States, National Military Family Association, Naval Enlisted Reserve Association, Naval Reserve Association, Navy League of the United States, Non Commissioned Officers Association, Reserve Officers Association, the Retired Enlisted Association, the Retired Officers Association, United States Army Warrant Officers Association, USCG Chief Petty Officers Association & USCG Enlisted Association, United Armed Forces Association, the National Order of Battlefield Commissions—Associate Member, Army Aviation Association of America—Associate Member.

Mr. Chairman, the Military Coalition as well as other concerned organizations have been working diligently for the past several years to remedy what we collectively consider to be a grave injustice. This injustice allows a state to continue to tax the pension or retirement incomes of former residents once they leave that state to go to another jurisdiction.

It is no secret that the ranks of retired people in the United States are growing. With improvements in health care and treatment, retirees are living longer, more active lives. They move more readily from one locale to another, bringing with them very little except their retirement incomes. Often this pension or retirement check, earned over many years of hard work, is all they have to live on. Yet, Mr. Chairman, we have states today, who reach out and grab a portion of that retirement income, regardless of whether they have a continuing fiscal need to provide for these citizens or not.

The vehicle or method states use for this "grab" has come to be known as a "source tax." Simply put, a source tax is an income tax levied on the *total income* earned by a former state resident, regardless of what or where the source of that income may be—either from sources within or without the taxing jurisdiction!

Mr. Chairman, we strongly urge the Committee's favorable consideration for the plight of these retirees and of legislation which seeks to abolish this tax for the following reasons:

It would abolish a blatant form of "taxation without representation." Since the affected retirees no longer live in the state, derive no benefit from the state and can no longer vote in that state, they should not be taxed by that state;

In many cases, the moneys put into a retirement fund are taxed by the state at the outset. To allow the same state to tax it again is a form of double taxation;

With regard to military personnel and some federal retirees, oftentimes the only reason they were ever in the taxing state was as a result of their federal or military employment or assignment. Additionally, these people are subjected to multiple moves during the course of their careers, often living and working in several different states. Under the source taxing authority presently extant in these states, it is entirely possible that, at the end of their careers, these people could have source taxes applied on their retired incomes by each of these states—simultaneously—and yet not reside in any of them nor derive any benefit from them;

A tax of this nature has a totally chilling effect on the individual's constitutional right to freedom of movement and that freedom of choice enjoyed by all Americans. It makes former residents of source tax states virtual prisoners of those states by imposing a continuing liability on their pensions—no matter where they go.

Mr. Chairman, we would like to close with just one of the many stories we've received on this subject. An individual has worked hard all of his life, paid taxes to his respective state of domicile, saved whatever was left and invested in a modest retirement plan. Now the day comes to retire and realize a life's dream. The individual moves to a state with no income taxes and lives there for several years. Then one day, upon opening the mail, he finds a letter from his former state announcing that several thousand dollars in back taxes are owed, demanding immediate payment and threatening the loss of home and property, credit rating, etc., if payment is not received. Furthermore, he is informed that taxes will be owed on this retirement income for the rest of his or her life, because part or all of it was earned while working in the former state. The individual then asks himself why; why does he owe taxes to a state in which he hasn't lived for several years? Didn't he pay enough taxes while he lived and worked there? What is the former state doing for him? Is he going to have to live out his days constantly facing this tax burden? How is he going to live on the small pension he has earned if he has to pay these taxes every year as well as possibly having to pay additional taxes on any social security annuity received?

Mr. Chairman, we in the Military Coalition strongly believe that the only way to remedy this depressing and frustrating dilemma facing many senior retired Americans is to afford them the protection they have earned and deserve. And that way, Mr. Chairman, is to determine that such taxation is patently unfair to retirees, does directly or indirectly restrict their freedom of movement and freedom of choice in where they may live and that, therefore these forms of taxation should be legislatively prohibited.

Prepared Statement of the American Institute of Certified Public Accountants

Introduction

We appreciate this opportunity to submit written testimony on the state taxation of nonresident pension income. The American Institute of Certified Public Accountants (AICPA) is the national professional organization of CPAs, with more than 320,000 members. Many of our members are tax practitioners who, collectively, prepare income tax returns for millions of Americans.

Support for H.R. 394

The AICPA supports H.R. 394, which prohibits states from imposing an income tax on the retirement income of an individual who is not a resident or domiciliary of the state at the time the pension payment is received. The main reason for our support is that there is presently no administrable system to consistently, fairly, and efficiently allocate retirement income based on the state in which it was earned.

We are pleased that H.R. 394:

Applies to both a nonresident's periodic and lump sum distributions;

Covers payments from all retirement, pension, or profit-sharing plans, not just those that qualify for special tax treatment under the Internal Revenue Code; and

Does not cap the amount of distributions exempted from the source tax.

We also support the objectives of H.R. 371, but are concerned about the uncertainty created by the bill's failure to clearly define "pension income."

We oppose the narrower approach taken in H.R. 744, which would provide relief only for certain qualified plans, and then only for benefits paid in certain annuity or installment forms and only for the first $25,000 in benefits paid in any other form in a single year. These restrictions prevent H.R. 744 from solving certain significant problems, described below, created by nonresident state taxation of retirement income earned while a resident of the state.

State Tax Laws

States tax income under two alternate theories: residence and source. The United States Supreme Court has long recognized the ability of states to tax the income of their residents based on domicile or residence. The Court has also supported the principle that states can tax residents on all their income wherever earned, while states can tax nonresidents on only the income derived from sources within the state.

For tax purposes, states have typically followed the federal rule in deferring taxation of retirement contributions and the like. At the time when retirement income is received, however, issues are raised at the state level that are not relevant to the federal level. For example, the source of the income may need to be considered when an individual has worked in more than one state or resides in a different state at the time the payment is received than at the time of contribution. Importantly, upon becoming a nonresident, the states historically have not taxed the deferred income, including deferred income from gain on sale of residence and unrealized capital gains.

Constitutionally, states may not tax the portion of a nonresident retiree's retirement income that accumulated while the retiree was a nonresident. However, some states assert that they can tax the retirement income that accumulated while the retiree was a resident. These states have enacted, or are now in the process of enacting, laws and adopting regulations to tax the retirement income of former residents. Notably, they argue that it is irrelevant that a retiree has long since severed all ties with that state.

Most states understandably view tax-favored retirement plans as deferral mechanisms rather than as avoidance tools. We recognize that it may not be equitable for a taxpayer to have enjoyed the benefits and opportunities of living in a particular

state and then avoid that state's tax on retirement benefits by moving to another state. If the taxpayer moves to a different state upon retirement, the deferral on retirement income can lead to reduced tax revenue for the nonresident state, and if taxpayers move from higher tax states to lower tax states, overall taxes may be reduced.

However, other states insist they will tax the retirement income of their residents regardless of where the retirement income was earned. Consequently, many retirees are now unfairly placed between two or more states, each imposing a tax on retirement income. Given the overwhelming complexities in the current environment, with a system that is not administrable and does not allow the tax to be allocated to the states simply, we support H.R. 394 as the best overall solution.

Problems With the Current Environment

As discussed above, many retirees are unfairly entangled in the conflicting tax rules of various states. These retirees now face an undue compliance burden, needlessly incurring burdensome accounting and legal fees to interpret state statutes and prepare multiple state filings for retirement income that may have been earned in other states. Taxing retirement income in this manner often results in double taxation. Further, the record keeping required to track the multistate retirement earnings would place an undue burden on employers and plan administrators.

Substantial practical and equitable problems exist in dealing with the state taxation of nonresident retirement income. Specifically, for taxpayers who worked in multiple states before they retired, devising an accurate and equitable mechanism for tracing retirement income to each state is a nightmarish burden. The employer and employee retirement contributions and the subsequent plan income must be separately traced and allocated by some reasonable method. Employer and employee contributions might be allocated to the state where the related employee services were performed each month. As discussed above, if the state where the services were performed was not the employee's resident state at that time, both of those states plus the state of the retiree's residence may claim the right to tax the income relating to the contributions. Additionally, an increasing number of retirement plans now accept rollovers from other plans. To account for the source of distributions, a plan accepting rollovers would have to account not only for the benefits accrued under that plan, but also for benefits related to the plans of the participants' prior employers.

In addition, for many retirees, the investment earnings accumulated in their retirement plans are significantly larger than the plan contributions themselves. Like the plan contributions, the investment income of a tax-qualified retirement plan is tax deferred. It is generally agreed that states may not tax a nonresident's investment income. Yet this is the result of states taxing retirement plan payments that represent investment income earned while the taxpayer is a nonresident. To correct this, states would need to limit their taxation of the retirement plan's income to that portion earned while the taxpayer was a resident of that state. This would create an even greater level of difficulty in compliance. Consequently, the retirement plan trustees or retirees would have to allocate income by the retiree's state of residence at the time the monthly income was earned, instead of by the state where the retiree's services were performed.

We have reviewed the testimony before the Subcommittee on this subject and agree wholeheartedly with Mr. Randall L. Johnson's assessment of the administrative and recordkeeping burdens of the current system. Although some states have credit mechanisms for taxes paid to other states on income taxed in the home state, they are far from perfect because of varying treatment and different rates. As CPAs, we feel these additional record keeping complications and double taxation results are not justified. We would reconsider this issue if a system could be developed to make a source tax more administrable.

Conclusion

Although there are some valid arguments in favor of a source-based tax, the lack of administrability of such a system causes us to be in favor of prohibiting the taxation of nonresidents' retirement benefits. Unless states are prohibited from taxing the retirement income of nonresident retirees, more and more retirees will be subject to double taxation, while an increasing number of employers will be subject to steep administrative costs and increasingly complex tax accounting problems. Therefore, we respectfully request that you support H.R. 394, prohibiting states from taxing all nonresident retirement income.

Prepared Statement of C.M. Sgt. James E. Lokovic, USAF (Ret.), Director, Military and Government Relations, Air Force Sergeants Association

Mr. Chairman and distinguished committee members, military members currently face a tax penalty for serving their nation. The 160,000 members of the Air Force Sergeants Association ask your assistance in preventing this practice. Currently, a significant number of military retirees are forced to pay taxes on their military retired pay to states where they were once stationed, but where they are not currently residents—a practice called "Source Taxation." AFSA represents the millions of enlisted active and retired, Air Force, Air Force Reserve, Air National Guard members and their families.

Military retirees are effectively penalized by these states for having been assigned to serve there. They were stationed in those states by the federal government—not as a result of their own choice. While stationed there on active duty, they were subject to paying the taxes where they resided. Once retired, the military retiree is subject to paying taxes of the state where they currently live. Action must be taken to prohibit other states from claiming a legal right to this already-limited retired pay.

Source taxation is unfair, burdensome and wrong, most especially for enlisted retirees, whose income is the lowest of military retirees. It is the federal government's responsibility to take action to end the practice targeted against those who served our nation. This retirement was hard-earned through years of difficult life, often at the risk of their personal safety. They deserve to pay no more than other citizens and in ways no more unfair than the rest. If anything, there should be a break for those who fought our wars and helped secure our peace—not a penalty.

Military members are unique in that their retired pay was earned dollar-for-dollar from a career of service to their nation, not to the individual states in which they served. It is wrong for any state to claim part of a retirement income when the individuals being taxed no longer live within that state.

AFSA strongly believes military retired pay is not a "pension" that states can lay a claim to as the result of work performed within that state. Military retired pay is deferred income, the result of years of relatively low pay and sacrifice far above what most people experience. Military retirees serve a career, with the expectation of a secure retirement income after their last assignment. Source taxation is just plain wrong.

Keep in mind that most enlisted members served in numerous states during their careers. In each case they paid taxes like any other citizen. For those who served in more than one state that practices source taxation, it is the most unfair. Again, these retirees did so under government orders. To lose parts of their retirement to more than one state is most burdensome. At worst, enlisted retirees should be taxed by the state where they currently reside and receive services.

Mr. Chairman, we have seen a growing agreement that source taxation is a fundamental unfairness that must be ended. There is legislation before Congress to stop it. We need your help to make it happen. As always, AFSA is ready to assist you in matters of mutual concern.

Prepared Statement of J. Randolph Babbitt, President, Air Line Pilots Association

On behalf of the Air Line Pilots Association, representing 43,000 commercial pilots at 35 air carriers, I wish to express our strong support for H.R. 394, Representative Vucanovich's bill to prohibit states from taxing the retirement income of nonresidents. This practice, more commonly known as "source taxation," is in the purest sense taxation without representation.

State taxes create state revenue. State revenue is then allocated to provide services to state residents. This process is all determined by elected state officials. However, nonresidents do not enjoy the benefits of this allocation process, nor can they affect the process through the ballot box. ALPA believes that this is fundamentally unfair and that Congress must act to stop it now.

During their careers, airline pilots, by the nature of their profession, may reside in many different states before they are required to retire. If taxation of retirement income of nonresidents were to expand beyond the current few states that currently practice it, an administrative nightmare would be created that not only would burden the individuals, but also, the companies that employed them.

Congress clearly has the authority to enact legislation to curb this practice. In fact, on three previous occasions, Congress has prevented the states from taxing the earnings of nonresidents, such as flight crews, military personnel and, of course, its own members. The case for retirees who move to another state is no less compelling.

Opponents of H.R. 394 argue that a cap should be placed on the pension income that is exempted from source taxation or that only income from a qualified plan should be exempted. We do not agree with either of these alternatives because this tax is unfair to all retirees regardless of their income. Furthermore, since Congress has frequently changed the pension laws in recent years to raise revenue, individuals have been forced to move more of their retirement income into unqualified plans—a legitimate way to provide for retirement income. They should not be penalized twice.

In conclusion, Mr. Chairman, ALPA strongly supports H.R. 394 and urges its swift enactment. I respectfully request that this letter be made part of your Subcommittee's hearing record of June 28, 1995.

Thank you for your consideration.

PREPARED STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

The Investment Company Institute[1] supports the bill introduced by Congresswoman Barbara Vucanovich (H.R. 394) that would prohibit "source state" taxation.

"Source-state taxation" is the assessment of state income tax on pension distributions made to a nonresident on the basis of the portion of the total pension that was earned while the retiree worked in that state (the "source state"). There currently is no uniformity among the states regarding the taxation of source state pension income of nonresidents. While many states have laws on the books that technically call for income taxes to be paid on such nonresident pension distributions, enforcement of those laws has been inconsistent.

The U.S. mutual fund industry strongly supports the proposed legislation. It addresses our concern that multiple state taxing authorities not require mutual funds to file reports on or withhold source state income taxes where they do not have access to the information needed to comply. Mutual funds typically have no means of tracking the states in which pension plan participants and IRA owners earn their pension and the amount earned in each state. Inasmuch as those determinations are central to source state tax calculations, mutual funds ordinarily are not going to be able to allocate pension distributions by source state.

Compromise bills, that propose to exempt only some portion of a person's retirement income from source state taxation, would only complicate this problem. Distributions from a mutual fund often represent only one part of a person's total retirement distributions. Mutual funds, therefore, in addition to being unable to identify source states, ordinarily will not be able to determine whether the pension distributions they make are in excess of any partial tax exclusion.

In short, mutual funds and similar financial institutions simply are not able to serve as vehicles for the collection of state income taxes on pension distributions made to nonresidents. The Vucanovich bill would solve this problem by providing a blanket prohibition on any State imposing income taxes "on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)."

The Institute strongly supports the Vucanovich bill. It is a straightforward, uncomplicated measure that would eliminate significant administrative and operational problems for mutual funds and other third party payors of pension distributions.

PREPARED STATEMENT OF ROBERT T. SCULLY, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF POLICE ORGANIZATIONS

My name is Robert T. Scully and I am the Executive Director of National Association of Police Organizations (NAPO). I am also a former Detroit police officer retiring 2½ years ago after 26 years. NAPO is a national law enforcement organization representing over 185,000 sworn law enforcement officers and 3,500 police associations and unions throughout the country. NAPO represents its members through federal legislation, education and legal advocacy.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes *5,604 open-end* investment companies ("mutual funds"), *470 closed-end* investment companies and 11 sponsors of unit investment trusts. Its mutual fund members have assets of about *$2.325* trillion, accounting for approximately 95% of total industry assets, and have *over 38 million individual shareholders.*

I would like to thank Chairman Gekas and the members of this subcommittee for holding a hearing on an issue that could affect the retirement of every American who relies on income from a qualified pension.

The problem of certain states imposing tax upon the pension payments of non-resident retirees presents serious concerns such as taxation without representation. Thus, retirees are asked to pay taxes to a state that provides them with no government services for which they have no recourse at the ballot box during elections.

In addition, these retirees are being double-taxed because they must also pay taxes to the state in which they currently reside. And, in non-income tax states like Washington, there is no way for them to credit source taxes paid on their income tax return.

NAPO has a resolution in strong support of the legislation pending before the Subcommittee that would limit the ability of the states to tax the disbursements of qualified pension plans. In the past, NAPO has supported the efforts by Representative Vucanovich and others to limit these source taxes which pose an enormous threat to retired public sector employees.

Legal experts have determined that Congress has the authority to limit source taxes and legislation has passed both Houses of Congress in the past, but unfortunately never was signed into law.

Law enforcement officers, like other public and private sector employees, plan their retirement on a certain number of years worked and pension income earned. To add to a fixed pension the burden of another state tax is both unnecessarily punitive and ludicrous.

This issue is particularly alarming to law enforcement Officers as municipal and state public employees because their paymaster has the ability to withhold taxes before disbursement.

Again, I thank you Chairman Gekas, for giving the National Association of Police Organizations the opportunity to express our views on an issue of great importance to current and future retired law enforcement officers in this country.

On behalf of our members throughout the country, we urge you to expeditiously report legislation to limit taxation of non-residents' pension income.

Prepared Statement of Carolyn M. Kelley, Director of Government Affairs, American Payroll Association

The American Payroll Association is submitting these comments in support of H.R. 394 and its companion bill in the Senate, S. 44, proposed legislation which would limit the ability of states to tax the pension income of non-residents. We believe that this legislation is necessary to protect both retirees and their former employers from the unreasonable burdens associated with the efforts of certain states to tax these payments.

The American Payroll Association is a nonprofit professional association representing 11,000 companies and individuals on issues relating to wage and employment tax withholding, reporting, and depositing. Over 85% of the gross federal revenues of the United States are collected, reported and/or deposited through company payroll withholding. Under our system of voluntary compliance, we are the nation's tax collectors. We have previously voiced our support for H.R. 394 and S. 44 as a co-signatory (along with a large number of groups and individuals) of a letter supporting the legislation because of the negative impact state non resident taxation has on retirees. In addition, we support this legislation because of the substantial concerns of payroll tax administrators about the increasing burdens imposed on employers by states' enforcement of "source taxation."

We believe that, to be truly beneficial, any legislation limiting state taxation of non-resident compensation must be at least as broad as H.R. 394 and S. 44.[1] These bills provide the relief necessary to alleviate the problems facing employers by exempting *all* payments from qualified employer pension plans. If Congress adopts legislation to exempt only *annuity* distributions from qualified pension plans (like the bills proposed in 1994), or if the 1995 legislation applies only to payments of certain types of qualified and nonqualified deferred compensation made after the law is enacted, all employers will remain exposed to state payroll audits with re-

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[1] Even these bills may not be broad enough to cover all of the payments an employer may make after an employee is no longer a state resident. Although the legislation includes payments from "any plan, program or arrangement described in section 3111(v) (2) (C)," the IRS may, by regulation, exclude such payments as stock options, vacation pay, and bonuses which are deferred for a short period of time from the definition of deferred compensation under Code section 3111(v). In that event, employers may still have to deal with state reporting requirements for non-resident former employees.

spect to payments to former state residents of retirement benefits not covered by the legislation. Any Congressional override of state source tax enforcement that may be adopted should be applied not just to all future payments of retirement income to former employees who have moved out of state, but also to all such benefits which are *reported* after the date of enactment, or, better yet, to all state payroll audits with respect to retirement income of nonresident former employees which may be conducted after the date of enactment.

Background. Currently, many states impose income tax on post-termination payments of pensions and non qualified deferred compensation that was earned and deferred while an individual was a resident of that state even though, by the time the payments were made, the individual had moved to another state (often one with lower or no income tax). These states base their right to tax non-resident retirees on the "source-tax" rule, *i.e.,* a state may tax income earned within its borders. As a result, the state establishes a right to tax that portion of the individual's benefits attributable to the period of time that the individual worked in the state.

As a corollary to the imposition of income tax on these post-termination payments, many state income tax laws require employers to withhold on these payments. Less than a dozen states currently enforce these "source" taxes, but state revenue constraints have caused more states (and cities) to conduct payroll audits of employers. Instead of attempting to collect unpaid income taxes directly from former residents, states recognize that it is more efficient to audit (and assess a liability against) a single employer than to audit dozens (or hundreds) of that employer's employees individually. *Employers* are liable, (and thus potentially subject to audit) both (1) for failing to report pensions and other deferred compensation based upon the state(s) where the employee worked or lived while the compensation was earned, and (2) for under withholding "source taxes." Also, the penalties assessed on employers may *exceed* the amount of taxes that would have been owed by the employees.[2]

The potential impact on employers from this attempt by states to extend their reach to tax the retirement income of individuals who no longer live in the states is expected to be costly and far-reaching, both in the substantial administrative expenses the employers will incur to maintain the necessary records and in the liability they may face if they fail to withhold the amount of source taxes the state has determined is appropriate.

Administrative costs. The *costs* to employers of compiling the data on pension accruals (and interest on previously vested accruals) on a state-by-state basis will be staggering. Compliance is very expensive because employers face huge administrative expenses of tracking and allocating pensions (and any other types of deferred compensation) based on the employee's residence (or job location) when the services were performed, and applying myriad state withholding laws to these computations. Employers also worry that federal guidelines will create an incentive for *more* states to tax what federal law allows them to tax.

The following simple example illustrates the complexities that employers will face if each state is allowed to continue taxing pension and other post-termination payments of compensation based on the state that the employee worked in when the payment was "earned" where an employee has worked for the same employer in two separate states. Consider the employee who worked for a company for 40 years (from age 20 to age 60). After working for the company for 10 years in State A, the employee is transferred to State B, where he continued to work for the next 30 years. At the time of the employee's transfer, the company's recordkeeping system, like many companies' systems, was not automated. Also assume that, as with many pension plans, the employee's pension is based on a maximum of 30 years of service, and is calculated as a percentage of his final pay. When the employee started with the company 40 years ago, he was making $4,000 per year; when he left, he was making $50,000 per year. He now receives a pension of $3,000 per month. Each state in which the employee worked imposes a tax on his pension income based on its "source taxation" rules. Both State A and State B have placed the ultimate burden on the employer to determine how to allocate the "source" of the employee's pension income. To do this, the employer must resolve a multitude of questions, and each state will probably demand that the employer answer them in the way that is most beneficial to that state. For example, if there is a 30-year service cap under the pension plan and the employee worked for 40 years, do the last 10 years of the employee's service in State B count as a factor in determining the "source"? The employee had already reached the maximum percentage of final compensation under his employer's plan after only 20 years in State B. But the employee's pension is based on his final compensation, which, as with most employees who worked through years of high inflation, is substantially greater than his compensation in

[2] See the discussion below of "Employers' liability for non-withheld taxes."

his first 10 years of employment. So should State A receive little or no allocation under the "source taxation" theory? And what if, as many pension plans do, the employee's plan offered an early retirement subsidy to employees who retired after age 55? Does this tip the balance in favor of State B? And if State A and State B disagree, who must suffer?

An even more fundamental and daunting task than answering these questions may face many employers who must substantiate the portion of the retiree's income which is allocable to each state. Before an employer can allocate income to a particular state, it must accumulate the records necessary to determine the state in which the income was earned. While most employers maintain the records necessary to calculate an employee's pension, such as his years of service and possibly even his compensation record, it is unlikely that any employer will have a record of the state in which the employee worked in any given year, especially if the employer is asked to retrieve records that are 40 years old (or more). Absent this information, it is likely that each state will assess a tax on the entire retirement benefit and require the taxpayer or the employer to prove that the amount is incorrect.

Employers' liability for non-withheld taxes. Most states have provisions (resembling Federal tax penalties) which impose penalties on *employers* for failure to withhold income taxes. The *Federal* penalties equal 100% of the non-withheld income taxes (calculated at a rate of 28%), *plus* up to 20% of the income not reported on an information return,[3] plus possible additional penalties for inaccurate quarterly payroll tax returns, totaling as much as 55% of the unpaid taxes. The employer's liability for the income taxes (but not the other penalties) can be abated if the employer proves that the employee actually reported the income. However, where income is *never reported* on any information return, very few employees ever voluntarily declare (and pay tax) on that income to that state. Assuming that the states have audit penalties similar to the federal penalties, employers are very concerned that they will be penalized (instead of the retirees) for their failures to withhold state income taxes on post-termination payments to former workers.

Unclear reporting guidelines. The concern over the possibility that states will impose excessive recordkeeping requirements on employers or assess substantial penalties against them has caused employers to seek relief from this burden. Some employers have argued that, by merely moving the pension trust monies to a state in which the employer does not do much business, and hiring an out-of-state tax administrator, the employer is no longer liable to file Copy 2 of Forms W–2 with any states where the trust and plan administrator do not "do business," because the state has no jurisdiction where the business nexus is lacking.

Single wage reporting may give more states information to audit employers. The necessity of enacting legislation which eliminates the ability of states to tax nonresident pensions has been heightened by the expanding availability of Federal information to the states. Attached is a brief article which provides just one example of the implications of such information sharing in the W–2 area, where states might legitimately expect employers to provide state information. If a single state found 5,000 *employers* (not individual employees) who had not complied with reporting procedures regarding *current* wages and income, it is reasonable to assume that an overzealous state might attempt to establish a multitude of violations when auditing an employer's reporting of each state's allocable share of a retiree's pension income. As the Internal Revenue Service begins to implement its new "simplified tax and wage reporting system" ("STAWRS") (which combines state and Federal information returns, and will give states access to the *Federal* government's data bank on wage and income information), the states will have a vastly expanded data base in which to audit employers for their potential errors in underreporting and under withholding state taxes. Moreover, if any state can assess large taxes and penalties on employers for years in which single wage reporting is in effect, it may *also* try to collect similar taxes and penalties from the same employers for the open years *preceding* the adoption of single wage reporting.

For all the reasons listed above, the American Payroll Association supports H.R. 394 and S. 44, suggests broadening the effective date of these bills, and urges the members of the House of Representatives and the Senate to support and cosponsor this legislation. This action is badly needed because the potential impact of state "source taxation" of pensions on retirees and their former employers is extensive

[3] Code §6722 imposes a penalty of up to 10% of any income not reported on an employee's paper copy Form W–2; Code §6711 imposes an additional penalty of up to 10% of any income not reported on the *IRS* copy of the Form W–2 (or on the IRS magnetic media tape). Although the IRS typically assesses only one of these penalties, technically both penalties could be assessed.

and troubling. We would be pleased to testify at any future hearings which may be held on this proposed legislation.

Mr. GEKAS. The subcommittee stands adjourned.

[Whereupon, at 11:45 a.m., the subcommittee adjourned.]

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